THE WORLD'S MONETARY PROBLEMS

THE WORLD'S MONETARY PROBLEMS

TWO MEMORANDA

BY

GUSTAV CASSEL

CONSTABLE & COMPANY LIMITED
LONDON. BOMBAY. SYDNEY

CONTENTS

FIRST MEMORANDUM

CONTENTS

CONTENTS

SECOND MEMORANDUM

FOREWORD

THE two memoranda here printed were originally written on invitation of the League of Nations, the first for the International Financial Conference in Brussels in 1920 (originally published in Vol. V. of the Proceedings of the Conference and now reprinted by permission of the League), the second for the Financial Committee of the League of Nations for their meeting in September, 1921 (not hitherto published in any form). The two memoranda are so intimately connected with one another that it has been thought desirable that they should appear together in book-form. It is also hoped that this publication may give a wider circle the opportunity to study the nature of the present monetary difficulties and of the means for restoring sound conditions which I have tried to expound in recent years.

GUSTAV CASSEL.

DJURSHOLM, SWEDEN.
October, 1921.

THE WORLD'S MONETARY PROBLEMS

FIRST MEMORANDUM

I

THE FUNDAMENTAL FACTS OF THE MONETARY SITUATION

The most conspicuous features of the economic changes which have taken place during the war and since are: an enormous increase in the supply of money, a decrease in the supply of commodities, and an enormous rise in prices.

Before entering upon an analysis of these changes, their causes and their mutual relations, some attention should be given to an investigation of their nature and of the ways of measuring them.

As to the *increase in the supply of money*, we have then first to observe that the gold standard which, before the war, formed the common basis of most monetary units and kept them in nearly fixed relations to one another has, in most countries, been given up and replaced by paper money without any definite relation either to gold or to the paper money of other countries. The new paper standards are, therefore, quite independent of one another and the increase

in the supply of money is a fact which must be considered separately in each separate currency.

In regard to the supply of money, we have to give special attention to those means of payments which are recognised as "*legal tender*," and which, therefore, always *must* be taken as payment. The supply of such money has obviously a fundamental influence on the total supply of means of payment. This money is either metallic coins, notes of the central banks or paper money issued by other institutions. To them may be added notes of private banks, paper money issued by local bodies and similar material means of payment which, though not having the character of legal tender, are actually circulating at the side of such money. The total sum of these material means of payment which is at any time in the hands of the public (*i.e.*, outside the issuing institutions) is the "*circulation*" of the country.

There has been, since the beginning of the war, an enormous increase of this circulation in every country, but the rate of this increase has been very different in different countries.

In addition to this increase of circulation a more or less proportionate increase of bank deposits, used as means of payment, has taken place.

The circulation itself has, in most countries, altered its composition. Gold coins have nearly completely been drawn out of the circulation in all countries. In many countries the same is the case with token coins of silver and sometimes even with those of copper or nickel. In some countries the circulation of silver coins has been increased by silver coins pouring in from countries with the same monetary unit. This is, *e.g.*, the case in Sweden, where Danish silver coins

are in general circulation, and in Switzerland, which has received a lot of silver francs from other countries of the Latin union. If we wish to have a reliable measure of the increase of circulation it is necessary to take into consideration the sums of coins in circulation now and before the war. These sums are never exactly known, but it is better to use some approximate figures for them than to leave them out altogether, for metallic coins have in many cases represented a considerable part of the pre-war circulation, and every error in our estimation of this figure will cause a proportionate error in the calculated relative increase of the circulation.

In some countries only a part of the circulation is *active*. One part may be hoarded within the country and another part may have been exported to foreign countries. Hoarding seems to have been relatively more important during the first months of the war than it has been later. At present there is probably in most countries not much more hoarding than would correspond to the customary pre-war hoarding, and it is then not necessary to take any account of hoarding in the calculation of the relative increase of circulation.

The part of the currency which has been exported to foreign countries is in some cases very important. The actual circulation within Germany is, *e.g.*, much lower than the total mass issued, the rest being held in foreign countries. This must be taken into account if we wish to have an idea of the active circulation within Germany.

In some cases it is necessary to have regard to an increase or decrease of the geographical area within which the currency is used. In the case of Germany, *e.g.*, the present active circulation should strictly be

compared with the pre-war circulation within the present boundaries of the country.

The customary ways of payment and of cash-keeping of a nation seem to alter themselves very slowly. Therefore, the proportion between the payments made by currency and those made by bank deposits must be expected, generally, to remain about the same, even though the volume of currency increases. This means that the volume of bank deposits should be expected to show about the same proportional rise as the active currency of the country. However, at a higher level of prices, some payments which used to be made in currency will have reached an amount which is preferably settled by aid of cheques. For this reason the volume of cheque payments and of bank deposits might riso somewhat quicker than the total volume of currency. This seems to have been the case in the United States.

In some Continental countries a deliberate and very intense action has been displayed by the governments and the central banks in order to encourage payments by cheques, the aim being to "save currency." A success for this campaign could hardly have diminished the total volume of payments and would, therefore, have had no other effect than to make the continually-rising figures of note issues somewhat less alarming in the eyes of a public which did not look deeper into the matter. However, these efforts do not seem to have had in any country much influence on payment customs. Where they have, to some extent, "saved currency," our estimation of the total increase in the volume of payments must only be proportionately raised.

Even in other cases it might be necessary, in order

to get a more exact measure of the increase in the total volume of payments, to take into account alterations in the payment customs of a nation. But such alterations nowhere have had that importance which sometimes is attributed to them by people trying to apologise for the enormous increase of the circulation.

A natural explanation for the great expansion of the means of payment which has taken place could have been found if the *supply of commodities* had swollen in the same degree. But quite the contrary has been the case. At the same time as the volume of the means of payment has grown, there has been in all countries a more or less marked decrease in the mass of commodities to be bought. This decrease has, however, been proportionately much less than the increase of the means of payment. Where the supply of commodities has been reduced by tens per cent., the means of payment have generally been increased by at least as many hundreds per cent. The scarcity of commodities has, therefore, from a monetary point of view, much less importance than is generally attributed to this factor.

The third group of economic changes which we have to take account of is the general *rise in prices*. A more or less exact measure of this rise is afforded by the several index numbers of wholesale or retail prices of commodities or of cost of living. The figures are mostly, to a certain degree, influenced by maximum prices enforced by governments; but it is an open question how far government price-regulations have really been able to keep down the general level of prices or whether the artificial restriction of some prices has caused a corresponding increase of the

unregulated prices. Where regulations have been ineffective, as they to a certain extent always have been, the official price statistics probably are based on legal prices only, and give in so far a false impression of the real rise in prices. The figures for the rise of the total cost of living are specially influenced by rents, which in most countries seem to have been kept down by legislation to a larger extent than any other prices.

This accounts, partly at least, for the lower degree of increase which these index numbers show in comparison with others.

The rise of prices has been very different in different countries.

As soon as the common metallic standard is abandoned and each country, as stated above, has got its own paper currency, the price level of each such country becomes a fact for itself, independent of the price levels of other countries. The often-heard talk of a general rise in "world prices" and of "international waves of rising prices" is under these circumstances singularly misleading and apt to foster false conceptions as to the nature of the phenomenon in question.

II

THE PROCESS OF INFLATION

The war has been financed by all countries involved, to a great extent, by means of creating more money, which has been, more or less directly, handed over to the exchequer, partly in the form of new issues of bank-notes or State paper money; partly in the form of extended bank credits, which could be used as means of payment. The latter method has indirectly caused a corresponding increase of the circulating medium of exchange to satisfy the increased demand for cash for smaller payments; for the proportion between the payments in bank credits and those in cash has, as stated above, been pretty constant as determined by the customs of each people.

The result of the creation of new money has been, in both cases, that a new buying capacity has been put at the disposal of the government. The total buying capacity of the community having in this way been increased without a corresponding increase in the commodities to be bought, a general rise in prices has followed. With higher prices, the need for means of payment has been increased proportionally, and the mass of the medium of exchange which could be kept in circulation has, therefore, at every time been proportional to the general level of prices. But

the *primus motor* to the enhancement of prices has always been the creation of an artificial buying capacity.

Under normal conditions, it should be observed, a fresh buying capacity is created only by production and marketing of commodities and services of a corresponding value, and such buying capacity does not tend to raise prices. As artificial, we must then denote a buying capacity which is not based on such production and which must, therefore, lead to a rise in prices.

Against the so-called "Quantitative Theory of Money" it is generally objected that an additional supply of money could not be expected to have such a considerable influence on the total buying capacity of the community as to cause a corresponding increase in all prices. It is also often held that no more money can be forced upon the public than the public asks for. Both these objections contain some truth. But a sum of fresh-created money put into the hand of an eager buyer, such as a government involved in a war, undeniably increases his buying capacity without taking a corresponding buying capacity from anybody else. Thus a certain rise of prices must take place in order that equilibrium should be restored between the community's buying capacity, as expressed in money, and its available supply of commodities and services to be bought. We cannot tell, on theoretical grounds, how great this rise in prices will be. But it is enough to know that some rise in the general level of prices must result from an artificially-increased supply of money. Given the new level of prices, the public need of money in circulation will have increased in proportion to the enhancement of prices which

has taken place, and just so much more money will be kept in circulation. It is quite possible, therefore, that a part of the fresh-created money will flow back to the issuing bank because the public does not want it. But the artificially-created purchasing power has had its effect in raising the general level of prices. Now if the same operation is repeated, the effect will be a new rise in prices and a corresponding new increase in the quantity of money which will be kept in circulation. If this process goes on month after month, year after year, the result will be a continued rise in prices and a continual and proportionate increase of the circulation of the country. This is just what has been going on before our eyes during recent years.

In this way an *inflation* has taken place in every one of the countries involved in the war. The process is essentially the same whether the artificial buying capacity put at the disposal of the government has had the form of bank-notes, other notes or book credits in the banks. With the rise of prices an increase will, as now explained, take place in all these means of payment irrespective of where the first addition is made. Nevertheless, the means of payment which have the character of legal tender, have a special importance in the process of inflation, for an increase of other means of payment will, generally, ultimately require a more or less proportionate increase in the stock of legal tender and is, therefore, so far impossible where no arbitrary additions to the sum of legal tender circulation can be made. Thus, ultimately, the process of inflation generally resolves itself in an arbitrary creation of more legal tender money.

Of course, no government has paid the war expenditures exclusively by inflation. The other way open

has been to get hold of the real savings of the people, either by aid of taxes or by loans. But neither of these ways involves an absolute guarantee that the means put at the disposal of the government represent real savings. It is generally recognised that war loans which are taken over by the banks, or by private investors by aid of advances of the banks, lead to inflation, and that the sound loans are those which are paid for by real savings of the investing public. But the same holds true in regard to taxes. And high progressive taxes on income and capital, especially those which are levied on business firms and public companies, are generally to a certain degree paid by bank assistance or by other forms of credit which may involve inflation.

Now, as soon as the State, in any form whatever, has given out more for the war than it could get at its disposal in the form of real savings, a rise in prices has necessarily been the result. The high prices have forced the great classes of the population whose incomes have not risen in the same proportion to severe restrictions in their consumption. In this way a certain amount of real commodities has been set free for the disposal of the State, who has been able to buy these commodities for the fresh money artificially created. Thus, ultimately, the expenses of the government have been financed, as they necessarily must be, as far as they are not covered by assistance from abroad, by the aid of real savings of the country. But these savings have to a large extent been compulsory and the means for this compulsion has been inflation. This inflation has, therefore, without doubt, been an effective means of war finance; but certainly a means which has caused great hardship to wide

circles of the people, and has had the most pernicious influence on the whole economic life of the country.

The process of inflation has also extended itself to neutral countries, which have been more or less compelled to give advances to the belligerents. As long as these advances could be kept within the limits of the saving capacity of the lending country they would not cause any inflation. But as soon as this limit was exceeded the advances could be given only by aid of creation of more money and the process of inflation began. Wide classes of the peoples concerned were forced to severe restrictions of their consumption, and in this way the real commodities were set free which had to make up for the buying capacity put at the disposal of the belligerents.

The war and its economic consequences have also in many neutral countries given rise to extraordinary State expenditure to cover which no adequate income has been found, and these financial burdens have, in such cases, had their part in driving the country into the road of inflation.

The process of inflation has not ended with the war; on the contrary, it has in many cases only been continued on a still larger scale. At the present moment, when our first aim must be to revert to stable conditions in monetary matters, it is naturally of special importance to trace the causes which are responsible for this continued inflation. The most general factor in this process seems to be an endeavour to keep down certain prices beneath the level to which they would have been brought up by the inflation or to relieve certain classes of consumers considered to be particularly oppressed by the high prices or otherwise in need of aid. The various measures taken to this end

have this in common, that they all tend to strengthen the consumers' monetary purchasing power, while some of them also tend to weaken production. The expenditure involved is either borne by the State (or by local bodies) or by certain classes of producers and owners of commodities. Instances of the first case are: Unemployment allowances; the selling of commodities to the poor beneath cost; general subsidies for lowering the prices of certain commodities, *e.g.*, bread, coal, railway fares; subsidies for house building; tariffs beneath cost in State enterprises, such as post, telephone, railways, etc. Instances of the second case are maximum prices on products such as coal, sugar, etc., and regulation of rents.

Uneconomically low prices on certain commodities keep consumption of these commodities on an uneconomically high level and retard the necessary adjustment of consumption to the limits prescribed by available supply. At the same time such prices leave the consumer with a greater purchasing power for other commodities than he would have possessed in the natural course of matters, and thus become a factor in raising the whole level of other prices. The artificial regulation of rents must particularly have had a considerable effect in this direction.

The public expenditure for the subsidy system now prevailing in so many countries is, generally, too big to be covered by any real income which could be put at the disposal of the State by taxes or loans; and the system, therefore, almost invariably drives the government to a policy of inflation. But to try to counteract the evil results of inflation by measures involving a continual fresh inflation seems singularly bad economic wisdom.

Of course, all sorts of extravagant government expenditure contribute to make the total financial burden too heavy, and thus to bring the exchequer to the point where further inflation is the only way left. From this point of view we must certainly regard the enormous military expenditures which still prevail in Europe as a very important factor in the process of inflation. That the revolutionary movements have the same effect, even in a still higher degree, is only too evident.

However, government finance is not the only factor to be taken account of in the process of inflation. Every extension of bank credits beyond the limit set by the fresh savings put at the disposal of the banks is apt to cause inflation. A certain restriction of the credit giving of the banks is therefore always necessary. This restriction is achieved partly by discriminating between the demands for credit, partly by a reduction of their amount and partly by the rates of discount or interest charged. Where these means are not applied with sufficient severity, the credit giving will involve the creation of artificial buying capacity; and if such practice is made possible by a supply of legal tender adapted to it, the result must inevitably be an inflation of the currency. This is in fact what has been going on since the war in a good many countries.

But even this form of deterioration of the currency is to a great extent a consequence of bad State finance. The industrial development of the country necessarily requires a liberal supply of fresh capital. When the State is continually absorbing most of the savings of the people there is not enough left for this industrial development and the requirements of bank assistance

will be very pressing. The banks will naturally hesitate in cutting down demands which seem to be of the first importance, for the enterprises as well as for the community at large. And if the way to creating fresh bank credits is open it most probably will be resorted to.

The recent development of the methods of taxation has without doubt seriously aggravated this situation. As all private income is used either for consumption or for saving, taxes must necessarily be paid either by a reduction of consumption or by a reduction of savings. There is no other choice. But the relative degree in which both these sources of taxes are used by the financial policy of a country has the most serious bearing on the economic development of the country. Now the tendencies in taxation which have prevailed during and after the war all go in the direction of placing the burden more and more on savings. This means that the State more and more covers its expenses by a continual consumption of the current savings of the people. Business enterprises are especially hardly hit by this pernicious practice, because they must pay out in taxes the money which in the first place ought to have served the need of fresh capital. In many cases the profits go, and must go immediately, to cover the pressing requirements of fresh money for the development of the business; and when the term for the payment of taxes comes on there is perhaps no free money left for the purpose. It is then necessary to apply for bank assistance, and if the enterprise is sound the bank cannot possibly refuse such assistance. But it may well happen that the banks, as a whole, have to give so great advances for payments of the taxes of their clientele

that an artificial creation of bank-money is unavoidable. In such cases it is clear that the taxation is a direct cause of inflation. But even if this result is avoided the wholesale consumption of the savings of the nation in taxes must have the most pernicious influence on the necessary capital supply of industry and trade, and may easily drive them into such situations that an arbitrary extension of credit making presents itself to the business community as the only possible way out.

In all countries the rates of discount of the central banks have been kept far beneath the heights which would have corresponded to the extraordinary scarcity of capital caused by the war and by extravagant State expenditure after the war. The rate of interest has, as all other prices, the fundamental function in social economy of restricting demand so far as the limited supply requires. With a too low rate of interest the equilibrium of the capital market is disturbed, and a need for artificial restrictions of the demand for capital arises, expressing itself in schemes for bureaucratic control of the use of capital, "rationing of capital," etc. Such means are always more or less pernicious for the wholesome growth of economic life, but they are seldom effective enough to bring about the necessary restriction of the demand for capital. And as long as the banks, and ultimately the central banks, have to meet greater demands than can be satisfied by real savings, an arbitrary creation of bank money is inevitable. Thus the result of an endeavour to keep down the bank rate beneath the point which the real scarcity of capital would require must always be an inflation.

There are obviously many interests at work to hide

this truth. But foremost among them stands without doubt the fiscal interest of a government in constant need of fresh loans or anxious to fund floating debts. Most governments have, under such circumstances, been inclined to keep down the bank rate in order to smooth the way for their loan operations. Such practice seems still to be in very general use. The business world is naturally against a high rate of interest which seems to work as a restriction on the development of economic life, and it is thereby only too easily overlooked that the real and necessary restriction lies in the scarcity of capital, and that the high rate of interest is only an expression of this scarcity. Labour might sometimes be aroused against a high bank rate, namely, when it begins to realise that dear money means a pressure on money wages.

Whatever now may be the reasons for keeping down the bank rate beneath its true level, such a policy always means a falsification of the money market, giving an impression of an abundance of capital which, in reality, does not exist. As long as there are objective limits to the supply of legal tender, the bank will very soon be reminded of the dangers of its policy; but when these safeguards are removed and legal tender can be supplied in arbitrary quantities there is nothing to show the bank unquestionably that it is on a wrong way, and the bank may well go on on the downward road of inflation in the *bona fide* belief that it is only supplying the business community with the money the latter has need of.

The actual process of inflation which we have to deal with now, at least in most European countries, is the combined result of an artificial creation of purchasing power in order to finance government

expenditure beyond the real capacity of the country, and a falsification of the money market by a too low rate of interest, in both cases with assistance of an arbitrary supply of legal tender.

III

EFFECT ON THE VALUE OF GOLD

Inflation of the currency and depreciation of the standard have in most countries driven the gold coins out of circulation. In several countries the chief part of the circulating gold was, already in the earlier stages of inflation, brought to the central banks by patriotic motives or by a strong pressure on the citizens. The gold has then been hoarded in the central banks. But even there it could not have been kept if the bank had freely paid it out against its notes. In most countries, however, the notes have been declared irredeemable and, when this formal acknowledgment of depreciation has been avoided, this has only been possible by a prohibition of every practical use of the gold, particularly gold export or the melting of gold coins for industrial purposes.

The general withdrawal of gold from circulation has naturally created a considerable abundance of gold for monetary use, and this abundance has probably in some degree been increased by the melting of articles of art or luxury caused by patriotism or by distress. Some central banks, as the Austrian and later on the German, have been forced to part with the greater portion of their gold funds, which have gone to increase the supply in other countries. To the superabundance

of gold thus created has been added the considerable production of gold since the beginning of the war. As the consumption of gold in the arts has probably been more restricted during the war than normally, this production must have had a special importance for the monetary supply of the metal.

The superfluous gold must of course find some outlet. It poured, during the first years of the war, into the central banks of the neutral countries of Europe, it went in enormous quantities to the United States, and even found its way to South America and Eastern Asia. But still the capacity to receive all this gold proved too small, and the yellow metal suffered a severe loss in value. In this way the masses of paper money created have in fact pressed down the value of gold as against commodities to less than half of what it used to be before the war.

In earlier cases when a country has flooded itself with paper money, the gold has gone out to other countries. Gold, thus having become more abundant in the rest of the world, has without doubt lost a part of its value, but in most cases a rather insignificant part. Now when gold has been driven out, not only from the circulation, but sometimes also from the central banks of so many and so large countries, there has been very narrow space left for the superfluous gold, and the following depreciation of the metal has necessarily been severe. The dollar at present most truly represents gold. The general level of prices in the United States being about 250 as against 100 before the war, the dollar has clearly come down to something about 40 per cent. of its old value measure in commodities and the same should then be the case in regard to gold. A fully reliable estimation of

the value of gold as against commodities is, however, hardly possible so long as the gold movements in the world are not free and so long as the value of gold, in consequence thereof, may be different in different countries.

The inflation of any monetary standard should of course not be measured by the agio on a metal which is itself depreciated, but by the agio that has to be paid for commodities, and no country must think that it has gone free from the process of inflation because it may see its way to resume gold payments.

The depreciation in the value of gold has, during the war, caused some neutral countries to protect themselves against an import of gold which would have meant a further depreciation of their monetary standard. Sweden, which in 1916 took the lead in this policy, has, however, only temporarily attained its aim, other depreciating factors, viz., more or less compulsory loans to foreign countries and extravagant State expenditure, having been quite predominant. The Swedish crown was, as a matter of fact, very much depreciated during the following years and has now, without doubt, lost far more of its purchasing power as against commodities than the dollar.

IV

THE ENHANCEMENT OF PRICES

THE creation of more money is not the only cause of a rise of prices. A reduction of the total mass of commodities to be handled by a given stock of money must have the same effect on prices, as long as this stock of money is unaltered. Such a reduction has probably taken place during the war in most European countries. If the mass of commodities decreases by 10 per cent. and the stock of money at the same time increases by 100 per cent., the result must be a rise of prices in the proportion of 90 : 200 or approximately from 100 to 222. The main cause of the rise of prices has in reality, as in this example, been the increased supply of money, the reduction of the mass of commodities having always played a very secondary rôle in this respect. For such a reduction is very sharp indeed if it surpasses the limit of say 20 to 30 per cent. But the stocks of money have very generally been increased by 200 or 300 per cent. and in the most impoverished countries even far more.

If the mass of commodities in any country diminished by 10 per cent., the stock of money of that country ought strictly to be diminished by 10 per cent. too. Where this is done no rise of prices will take place. In this sense one may say that every rise of prices is

caused by a too abundant supply of the means of payment and is proportional to this abundance.

Inflation has been defined by the Federal Reserve Board of the United States as "the process of making additions to credits not based upon a commensurate increase in the production of goods." (Fed. Res. Bulletin, July 1, 1919, p. 614.) But the omission to make reductions in credits commensurate to a decrease in the production of goods must have the same effect upon prices, and may therefore justly be called an inflation too. Thus we may speak of "Inflation" in a more narrow or in a more general sense. If there has been no increase in the mass of commodities, as is probably the case for most European countries during the war, the increased supply of money represents inflation in the narrow sense. But in a wider sense inflation is measured by the rise of the general level of prices.

The popular idea that a shortage in commodities could cause a rise of prices which would necessitate the creation of more money is obviously a fallacy.

Popular explanations of the rise of prices generally start from such factors as the high costs of transportation, the prohibition of imports, the diminished output of labour, etc. Such factors can obviously have an influence on the general level of prices only so far as they contribute to a decrease in the total mass of commodities. But so far due regard has already been paid to these factors in the explanation here given. Other factors which need to be set forth in the discussion refer themselves ultimately to an increased supply of money. This is the case, *e.g.*, when people speak of high wages, high costs of raw materials, etc., as causes of a general increase of

prices. In reality there can be no other independent causes of an upward movement in the general level of prices than those two which have been stated above.

V

INTERNATIONAL EXCHANGES—PURCHASING POWER PARITIES

Our willingness to pay a certain price for a foreign money must ultimately and essentially depend on the fact that this money has a purchasing power as against commodities and services in the foreign country. On the other hand, when we offer so and so much of our own money we offer, in fact, a purchasing power against commodities and services in our own country. Our valuation of a foreign money will, therefore, essentially depend on the relative purchasing power of the currencies of both countries.

Given a normal freedom of trade between two countries, A and B, a rate of exchange will establish itself between them and this rate will, smaller fluctuations apart, remain unaltered as long as no alteration in the purchasing power of either currency is made and no special hindrances are imposed upon the trade. But as soon as an inflation takes place in the money of A, and the purchasing power of this money is, therefore, diminished, the value of the A-money in B must necessarily be reduced in the same proportion. And if the B-money is inflated and its purchasing power is lowered, the valuation of the A-money in B will clearly increase in the same pro-

portion. If, *e.g.*, the inflation in A has been in the proportion of 320 to 100, and the inflation in B has been in the proportion of 240 to 100, the new rate of exchange will be three-fourths of the old rate (approximately the case of England and the United States). Hence the following rule: When two currencies have been inflated, the new normal rate of exchange will be equal to the old rate multiplied by the quotient between the degrees of inflation of both countries. There will, of course, always be fluctuations from this new normal rate, and in a period of transition these fluctuations are apt to be rather wide. But the rate calculated in the way indicated must be regarded as the new parity between the currencies. This parity may be called the *purchasing power parity*, as it is determined by the quotient of the purchasing powers of the different currencies.

During the war the buying capacity of the different monetary standards has, owing to the over-abundant supply of means of payment, been much reduced, though in very different proportions. Consequently the purchasing power parities have undergone very important alterations and are now quite different from the parities which were in force before the war. There is no reason to believe that exchanges will ever be restored, generally, to their old parities. These old parities have, in fact, lost their old significance and can no longer in any respect be regarded as normal. The constant references still made to them are a most serious hindrance against a clear understanding of what has really happened to the world's monetary standards. In statistics, likewise, it is only confusing to retain the old custom of converting foreign money on the basis of the pre-war parities.

The purchasing power parities represent the true equilibrium of the exchanges, and it is, therefore, of great practical value to know these parities. It is in fact to them we have to refer when we wish to get an idea of the real value of currencies whose exchanges are subject to arbitrary and sometimes wild fluctuations. Every care should therefore be taken to ascertain the rate of inflation of each country, as measured by the increase of circulation or by the rise of prices, and from these data calculate the purchasing power parities of the different currencies. Such figures, based on monthly mean inflation in different countries, ought to be laid before the world some few days after the end of each month.

In the popular explanations of the enhancement of prices a prominent place usually is given to the fact that prices have risen in other countries. In regard to the independent paper currencies now in use in most countries this explanation is obviously false. The exchanges adjust themselves, as we have now seen, to the general price level of each country. If, then, a general rise of prices has taken place in A, the value of the money of A in B will sink in the same proportion, and with this new rate of exchange the higher price level in A cannot cause a higher price level in B. If only the supply of means of payment in B is kept scanty enough the purchasing power of the B-money will be unaltered and quite independent of any inflation in A. On the other hand, a country which has kept up an effective gold standard must obviously experience a rise of prices commensurate to the fall in the value of gold referred to under III.

VI

ABNORMAL DEVIATIONS OF THE EXCHANGES

In the earlier part of the war, when a certain amount of freedom still was left for international trade, the actual rates of the exchanges used to coincide fairly well with the purchasing power parities. But later the sharp restrictions of the trade between nations have often distorted the exchanges from these parities. If trade between two countries is more hampered in one direction than in the other, the value of the money of the country whose export is relatively more restricted will fall, in the other country, beneath the purchasing power parity. This result is only in accordance with our general conception of the rate of exchange as an expression of the valuation of a means of securing the supply of foreign commodities; if this supply is made artificially difficult, the actual value of the foreign currency must sink in proportion. There are many instances of such abnormal deviations of the exchanges. Thus, the inflation in the United States has without doubt been much smaller than in Sweden, and the dollar has kept much more of its old purchasing power than the Swedish crown. The purchasing power parity must therefore have risen considerably above the old parity of Kronor 3.73 for the dollar. But the actual rate fell, during the time of the severest war

restrictions of American exports to Sweden, far beneath this old parity, the mean monthly rate for November, 1917, being as low as Kronor 2.55. As soon as the restrictions were removed, the dollar exchange rose to a height corresponding to the purchasing power parity and even, for a short time, above it. The explanation of the temporary undervaluation of the dollar is to be sought in the absence of any immediate employment for dollars in Swedish possession.

The restrictions of which we have to take account in this connection may be of different kinds. Absolute prohibition of export, prohibition with a system of licences, rationing of export, export duties, measures to keep up higher prices for foreigners than those of the inland market, etc., are samples of methods which have been in use during the war and are still retained in numerous cases. They all work in the direction of a corresponding depression of the international value of the currency of the country applying them. If this were clearly seen, the eagerness for such methods would probably be considerably mitigated. The restrictions can also take the shape of artificial hindrances or natural difficulties hampering transport from the country A to the country B more seriously than the transport in the opposite direction. The result will be some undervaluation of the money of A in that of B. The same result will, of course, follow from every import-restricting measure in B. Thus, the severe French import restrictions on luxuries tend to enhance the international value of the franc, or perhaps rather to counteract, to a certain degree, other influences tending to depress the franc beneath its purchasing power parity. The explanation is, from the French point of view, that foreign money is

no longer so much worth having when it cannot be used for acquiring foreign luxuries; and from the foreigner's point of view, that the import restrictions make it more difficult to procure francs.

We can imagine several other factors which might depress the international value of a currency beneath its purchasing power parity. But if there is no special hindrance against export from a country, every undervaluation of its currency will obviously call forth an increase of its export tending to counteract this undervaluation. For as soon as the currency of a country is undervalued in comparison with its purchasing power parity there will be a special profit in buying this currency and using the money to procure commodities from that country. The stimulus thus given to the demand must very soon bring the price of the currency up to the purchasing power parity. Therefore, where no extra restrictions on the export of a country are imposed, other causes depressing the exchange beneath the purchasing power parity can have only a temporary effect.

As instances of such depressing tendencies we can quote: a distrust in the future of a monetary standard, leading to a discounting of an anticipated fall of the internal value of the money; operations of speculators, etc. By far the most important of these depressing factors is, however, the practice of selling out the currency of a country abroad. This practice has, during the last year, reached such proportions and become such a prominent factor in the international monetary situation that it is necessary to devote special attention to it.

The whole operation can best be studied in the case of Germany. German marks have been sold out abroad

on an enormous scale, and at almost any price they would fetch. As the central government, local bodies, banks and business enterprises were in absolute need of foreign means of payment, and these did not seem to be procurable in any other way, the country was driven to this selling out of its currency. The process must be looked upon as a substitute—a bad substitute indeed—for the more regular device of securing foreign loans. As lenders could not be found, Germany turned to a new class of investors, the speculators in currency, and offered them, instead of a high rate of interest, the inducement of an extraordinary low rate of exchange. Of course, the speculators suffered heavy losses as the exchange went down step by step. But new ranks of speculators were always ready to believe that "the bottom has been reached"; as a matter of fact, the last of them have made enormous profits. The selling out of marks is said to have been considerably increased by the endeavours to evade in this way an exorbitant taxation.

Now, this process, carried on on such a scale, inevitably must have a tendency to depress the German mark beneath its purchasing power parity. Such a depression has also taken place, at certain periods, to a most alarming degree. When the mark was at its lowest international value it had certainly not more than a third or a fourth part of the value which would have corresponded to its internal purchasing power. It would, under such circumstances, have been extraordinarily profitable to use German marks for buying in the cheap German markets. In fact almost everything could then have been exported from Germany with great advantage. This was, of course, an impossible situation for Germany. She was simply compelled

to protect her scanty supplies of food and raw materials, and thus to prohibit exports of them. In regard to other commodities she tried to defend herself against buyers, seeking to take advantage of the low exchanges, by raising prices for foreigners to some multiple of the inland price. These measures, however, must, according to what has been stated above, have the effect of pressing down, permanently, the exchange value of the mark beneath its purchasing power parity.

On the other side, the measures have not been quite effective. It has not been possible to prevent the enormous buying capacity put into the hands of foreigners from reverting, to a certain extent, to Germany and making itself felt on its internal market, by forcing up prices even for inland buyers. This means, however, that the internal purchasing power of the German mark has been reduced. In fact, the general rise of prices in Germany during the last twelve months has been enormous. But then, of course, the purchasing power parities of the mark have been proportionally cut down.

From these experiences it seems clear enough what disastrous effects are connected with an endeavour to sell out a currency of a country to foreign speculators. Although the case of Germany is the most conspicuous, the practice has by no means been restricted to that country. Other countries which have been tempted on the same downward road should now see the necessity of stopping the process.

VII

EFFECTS ON INTERNATIONAL TRADE

EVERY alteration in the purchasing power parity of the exchange between two countries naturally must have a disturbing influence on their mutual trade. But as soon as this parity has been stabilised at a certain level it is of no importance whether this level is high or low. Thus, the export trade of a country is not hampered by low quotations of the foreign exchanges as long as these quotations only correspond to a high level of prices in foreign countries or a low level at home; nor is it specially stimulated by high quotations of the foreign exchanges as long as these only correspond to the relative purchasing power of the monetary standards quoted. Likewise, low prices on foreign currencies do not mean an encouragement of imports from them or a handicap for the home producer, provided these exchanges are a true expression for the purchasing power of the foreign money; on the same condition, high prices of foreign currencies do not in any way hamper the import from them. In fact, the terms "high" or "low" exchanges have no sense in themselves; if they are to be used they must obviously refer to the normal rates of exchange, *i.e.*, to the purchasing power parities. But when used, as is generally the case,

in reference to old parities which have lost all real significance they are in the highest degree misleading.

Equally clear it is that every deviation of the actual rates of exchange from the purchasing power parities must cause considerable disturbances in international trade. The export from A to B must be very much hampered if the money of B is quoted in A lower than would correspond to the general level of prices in B as compared with that in A. At the same time, the import to A from B would get an artificial stimulus from such a quotation. True, both these effects would tend to enhance the value of the B-money in A, and to bring it up again to its purchasing power parity, which shows that this parity is the true point of equilibrium for the exchanges.

But in reality this restoration to equilibrium may take a long time, especially if the forces depressing the exchange are strong and work continually. And this period may prove very disturbing for trade and industry in both countries. Generally, the country which has got its money undervalued is regarded as the sufferer, and the difficulties of its position are clear to everybody. In fact, however, it is not much better for the country whose currency is overvalued, such a country being exposed to quite a new sort of dumping of the most reckless and incalculable kind, and at the same time very much hampered in its export trade. Most European countries have had such disagreeable experiences of the extraordinary depression of the German mark during the winter 1919–20, while Germany herself has had to go through all the sufferings and curious disturbances of a country exposed to an abnormal undervaluation of its currency. But this is by no means the only case. There has been,

in the first months of 1920, a very substantial undervaluation of the French franc and the Italian lira in relation to British, American and neutral currencies. It is obviously of great importance that the fullest light should be thrown upon the causes of these abnormal movements of the exchanges and on their effects on trade.

Here we have, however, first of all, to emphasise the general truth that exchanges are disturbing to international trade only in so far as they deviate from their purchasing power parities. To judge the present exchanges from the point of view of the pre-war parities is a grave mistake, which is, however, incessantly repeated, even in otherwise sound expositions of the monetary situation. The result is that people often represent an exchange as being against a country when the opposite is the case, and *vice versa.* In questions of such vital practical bearing, no obscurity in regard to first principles can be allowed without serious risk, and it seems, therefore, highly desirable that a full understanding on this point should be arrived at. The world will never come back to the pre-war parities, and we shall therefore, in any case, sooner or later, have to accustom ourselves to look upon the new purchasing power parities, which, we may hope, will gradually crystallise themselves out of the present muddle, as the true parities.

The months of May and June of 1920 have witnessed a very sharp rise of the German mark. One could have imagined that this recovery should have been a great advantage for Germany, as well as for the countries trading with Germany, and, to a certain extent, this has undoubtedly been the case. But the very alteration and its suddenness have, in reality, proved almost

fatal, not only to the international trade of Germany, but also to her production and her whole internal economic life. These consequences have, naturally, been aggravated by the violent daily fluctuations of the exchanges which have taken place and which seem to have become worse and more incalculable than ever.

These experiences, and similar experiences in regard to other currencies, seem to show that exchanges which are very much depressed beneath their purchasing power parities are liable to more violent and arbitrary fluctuations than exchanges which move in the vicinity of their purchasing power parity.

Certainly, a situation which allows such fluctuations of the exchanges is quite intolerable: the complete impossibility of making an ordinary business calculation or an economic forecast of any kind threatens not only international trade, but the whole economic life of a continually growing part of the world with a complete breakdown.

When the exchanges move against a country—*i.e.*, when the currency of the country sinks in international value—people generally explain it as a result of an adverse balance of trade. But this explanation is obviously inadequate if the deviation of the exchanges is considerable, and has more than a quite temporary character. For if a country buys more from another than it sells to it, the balance must be paid in some way; say, by export of securities or by loans in the other country. Thus the balance of payments must on the whole equalise itself, and there is no reason for a definite alteration in the rates of exchange. Should such an alteration occur, it must generally be taken as a proof of an inflation which has brought down the

internal value of the monetary unit of the country and raised its general level of prices. With an unaltered price-level and an adverse rate of exchange, the country's export trade should get a strong stimulus, which would tend to bring the exchange back soon enough to its normal rate.

On the other hand, if an inflation has taken place, a new normal equilibrium of the exchanges *must* establish itself, quite irrespective of any balance of trade. If, *e.g.*, the French inflation is 600 (in comparison with 100 before the war) and the English inflation is 300, it is altogether superfluous to look for another cause to explain the normal rate having doubled from 25 francs for the £1 to 50 francs. (These figures are, of course, somewhat simplified, but may be taken as representing the essential of what has really happened.) If then, in addition, France suffers from an adverse balance of trade, this balance must be paid for by fresh credits, or by export of securities; and no further depression of the franc will follow. Were the country really cut off from all normal ways of procuring means of payment, and were it for this reason turning to sell out its own currency abroad to speculators, that would without doubt be a factor tending to a further depression of the international value of the franc. But even then a definite depression beneath the purchasing power parity could only take place if the export of commodities from France were particularly restricted, and the foreign holders of francs thereby cut off from a free use of their purchasing power on the French market. This ought to make it clear that an adverse balance of trade, or even, more generally, an adverse balance of daily obligations, is quite insufficient as an explanation of any lasting

depression of the exchange value of the currency of the country.

Now, if we are bound, on these grounds, to abandon altogether the popular theory of trade balances as an explanation of the movements of international exchanges since the beginning of the war, another very popular theory has to be buried too, viz., the theory that depressed exchanges can be corrected by an adjustment of the trade balance. In fact, it is very generally believed that a country which has seen the price of its money abroad sink very much below its pre-war parity will be able, after the war, to restore the old exchanges only by increasing its exports. This will certainly be possible if the low quotations of the money of the country have been caused exclusively by one-sided hindrances against its exports. But if they are signs of a deteriorated internal value of the money, no development of the export of the country can better the exchanges. These will in the future be governed exclusively by the purchasing power parities, and will therefore only be improved if the country succeeds in reducing its inflation, and thus in giving its monetary unit a higher internal value. But this is, as we shall see, a very complicated process, involving difficulties of another kind than that of increasing exports.

VIII

THE STABILISATION OF THE DIFFERENT MONETARY STANDARDS

If we really wish to make an earnest effort for the recovery of the world's economic life, we shall invariably find, from whatever point we take up the problem, that the first thing to be done is to stop the process of inflation. As long as inflation is allowed to go on, deteriorating still further the monetary standards, there is no hope for any work of reconstruction. Now, the stopping of inflation necessarily involves the establishing of a definite scarcity of money. Where the supply of money can be arbitrarily increased, demands for money will always be sure to come forward. Governments will spend more than the actual savings they have at their disposal, enterprising promoters will require more capital than the community can save, housing schemes will be pushed without regard to the real possibilities of the supply of capital, labourers will ask for higher wages and other labourers will follow them, tradesmen will increase their selling prices, and profiteers will take advantage of the general wave of price-enhancement. In one word, we shall have all the factors set moving which people generally look upon as the real causes of a general rise of prices. The deficiency of the popular explanations is plain

enough: these factors are *always* at work as tendencies; but they are, normally, kept within due limits by a definite scarcity of money, imposing the hard necessity of restriction. Only when this natural scarcity is done away with by measures allowing an arbitrary creation of fresh money, and when thus the sluices of inflation are thrown open, will the tendencies develop into factors actually at work in the process of price-enhancement. Therefore, the only possible way of combating this enhancement of prices and the rising cost of living is to restore the necessary scarcity of money, and definitely shut out all arbitrary measures tending to make the supply of money artificially easy. The popular idea that a rise of prices can be prevented by legislation enacting maximum prices and inflicting severe punishments on speculators and profiteers, while the country is incessantly flooded with fresh money is a fallacy which it is very important to get rooted out.

The problem of stopping inflation is obviously, in the first instance, a problem for each country to decide for itself. By carrying through such a policy, the country will be able to attain a *stabilised* standard of value; and whatever may be the further aims of the monetary policy of the country, this is undoubtedly the first thing to be done.

The general means of keeping up a monetary standard is the sufficient limitation of the supply of means of payment in that standard. The principal regulator of this supply is the rate of discount. In the whole world the rates of discount have been too low during the war. The real scarcity of capital would have commanded a much higher interest than the 5 or 6 per cent. which have generally prevailed, but which

have only been the results of a continual falsification of the money market. Even now, after the war, the world's need of capital is so great, in comparison with the scanty supply, that a real equilibrium can be attained only by the aid of higher rates of interest than those generally prevailing. This has begun to be more and more recognised, as is shown by the latest increases of the discount rates of some central banks up to 7 per cent. But still there are many countries lagging behind in this regard in the belief, as it seems, that they can really afford the convenience of a much lower rate; and curiously enough these countries are by no means always among the richest.

It is often said that a high rate of interest hampers production and makes it dearer. This is false. An interest policy which gives the scarcity of capital its true expression in a sufficiently high rate of interest can in no way prevent the productive powers of the community from being fully employed. It only directs these powers, to a certain extent, from future needs to present, and in this way it secures a better provision for the present than otherwise would be possible. If, *e.g.*, a sum of a hundred millions is spent in one year on some sort of future needs—say, on extensive house building—nearly all the money distributed will be turned into purchasing power claiming to be satisfied with commodities and services to be immediately consumed. But practically no such goods have been produced by this expenditure. Most probably, no new housing accommodation will have been provided during the year, and even in the following years only a very small amount of the original expenditure will be repaid, annually, by the housing accommodation procured. If the hundred millions

are not actually saved by some persons reducing their consumption so much beneath their income, the mass of consumable goods at the disposal of the community during the year will therefore meet a demand out of proportion to its value, and the result will inevitably be a rise of prices. Now, if the rate of interest had been raised so as to correspond to the real scarcity of savings, and if the sum spent on house building had been, in consequence thereof, reduced within the limits of real savings available, the productive powers of the community would have been directed to a greater extent to satisfy its immediate needs, and an equilibrium would have been attained between the buying capacity directed to consumption and the mass of consumable goods. Thus, a right interest policy would have prevented a rise of prices.

The first condition which must be fulfilled, if a stabilisation of prices shall be attained, is, therefore, that the rate of interest at which the banks lend their money shall, broadly at least, correspond to the real scarcity of capital.

Besides the rate of interest, there are other means for enforcing the necessary restriction on the demand for capital. The banks always discriminate between the proposals for which their accommodation is sought, and in periods of particular scarcity of capital it is only natural that this discrimination is made more severe than usual. It seems sound, under present circumstances, to discriminate particularly against a use of capital which, though preferable enough, will require a long time to become remunerative ; or which involves mainly the strengthening of a monopoly without adding materially to the productive capacity of the community ; or which is calculated to serve a

demand for luxuries which now ought to be excluded. But the proposition that is sometimes put forward that the banks should restrain their fresh advances to purposes of "public utility," refusing assistance even to the most profitable bargains or enterprises, seems thoroughly unsound, considering that it must be a rather important public interest—particularly in a poor country or in times of distress—that capital shall be used, generally, in the most profitable way. The device of using capital for "public utility" has, in reality, proved itself to lead to particularly wasteful dispositions of capital, without due regard to the actual limits of supply, and therefore to be one of the most prominent factors in the process of inflation.

The bureaucratic control of the use of capital which has been introduced in some countries does not seem capable of doing much good. If the rate of interest is kept so high as to correspond to the real scarcity of capital, there will be no need for a further restriction of the demand on bureaucratic lines. And if bureaucratic regulation is to supply the additional restriction to the market which a too low bank rate makes necessary, it seems almost sure that the employment of the available capital in the community will be rather uneconomical. Besides, the control itself must be a serious hindrance against trade and enterprise, and, therefore, must diminish the effectivity of the business life of the country.

The popular idea that it is possible to improve a monetary standard by heaping up gold in the vaults of the central bank must be abandoned. The value of the money of any country is determined by the scantiness of the relative supply of means of payment in that money. As long as this supply is not reduced,

no measures whatever can give the monetary unit a higher value. If the money of the country is kept about par with gold by a sufficient limitation of the supply of means of payment a gold reserve may prove useful for the actual carrying through of gold payments. But if this fundamental condition is not fulfilled, the gold in the vaults cannot save the currency of the country from being depreciated.

The value of the money of a country is often confounded with the credit of that country. It is believed that the low international valuation of the money is simply an expression of distrust in the country's financial situation, and, therefore, also that a higher value can be restored to the monetary standard if only the government can re-establish its credit. According to what has been stated here, this view must be false, though, of course, if a currency has been depressed, on international exchanges, beneath its purchasing power parity, an improved State credit may help to restore it to that parity. But the internal purchasing power altogether depends on the limitation of the supply of money, and the financial situation of the State has an influence on the inner value of the money only so far as it makes such a limitation possible.

If the stabilisation of the monetary standard depends on a limitation of the supply of money, and, therefore, ultimately on the supply of legal tender money, it would seem a simple solution of the problem to enact a rigid maximum for the issue of such money. But such a course will easily involve the country in the gravest difficulties if it is not combined with a policy suited to restrict the buying capacity in general. With an incessant creation of fresh buying capacity,

the need of legally recognised circulating means of payment will increase proportionally, and the rigid limits to the supply of them will, ultimately, prove unbearable and probably be abolished. If this supply, as in the case of the British currency, is made dependent on gold reserves, the formal limitation of the restriction of the currency will result in extraordinary efforts to acquire more gold, which efforts will be of little real use for the stabilisation of the monetary standard, but which, as we shall see later on, may make the ultimate restoration of the gold parity more difficult. Thus, the formal limitation of the issue of notes, important and, indeed, necessary as it may be, should not be thought to be more than a part of the general scheme required for the restriction of the total monetary buying capacity of the community.

IX

ITS EFFECTS ON STATE FINANCE

A STABILISATION of the monetary standard obviously cannot be attained by imposing restrictions on the business community only. Equally severe restrictions must be laid upon the government's demand for money. These demands have, as a matter of fact, been the chief factor in the inflation which has taken place since the beginning of the war, and cessation of inflation must consequently, first of all, require cessation of the manufacturing of money to fill the gap between State expenditure and real buying capacity put at the disposal of the State. Now there are limits to the real savings a government can get hold of by taxes or loans from its citizens. Pushing its demands beyond these limits, the government virtually drives the taxpayer or the buyer of government securities to rely upon bank accommodation, leading ultimately to inflation. Thus there are also limits to the expenditure a government can undertake without causing, directly or indirectly, further inflation and depreciation of the monetary standard of the country. Stabilisation of the monetary standard will in all countries require a severe restriction of the State expenditure which they have got accustomed to during the last years.

To cut down expenditure on a large scale is, however, a hopeless task without radical restrictions of the field of expenditure, and hence of the functions which the State pretends to fulfil. In the first instance, there is the attempt of governments to reduce, at the cost of the exchequer, the price of certain commodities and services beneath cost. Such practices must completely and as soon as possible be abolished. This involves, of course, an increase of prices for bread or of railway fares or postage, or of whatever may be the prices artificially kept down. But the buying capacity of the consumer is thereby reduced, and the result will be a tendency to depression of other prices. At the same time the government will be able to reduce their demand for artificially manufactured buying capacity, and thus a restriction will be laid upon further inflation. A cessation of all unnecessary direct subsidies to the unemployed or other consumers will co-operate to the same effect. Before entering upon any fresh scheme of subsidies, *e.g.*, for house building, the government should make sure that they can pay for it without fresh inflation.

Further, there is the military expenditure. Looking upon Europe from an outsider's point of view, we must recognise that the whole Continent is insolvent and cannot really afford the enormous military expenditure which still prevails. It is the common interest of Europe that its different countries should revert, in the nearest possible future, to stable standards of money. But this very modest and extremely important end can never be attained as long as Europe continues its hostilities, its military occupations and its internal rebellions, and as long as these practices call forth a need for armaments far beyond what

Europe can honestly pay for. Real peace conditions must be established, and this must be interpreted to mean friendly intercourse between the different members of the European State-family, earnestly co-operating in one great common effort to set the economic life of Europe going again. Those who regard this as a Utopian idea must realise what the alternative is: the continuation of the half-warlike conditions now prevailing does not only mean a direct and most serious hindrance to every revival of production and trade, but also a scale of military expenditure quite out of proportion to the financial capacity of the present Europe, and, therefore, inevitably leading to further inflation of its monetary standards. But what a prolonged inflation means should, at this moment, be clear to everybody: it means a progressive falling into pieces of all organised economic life, and of the moral forces which are its foundation, actual starvation for large classes of the population, growing social unrest, and, ultimately, the complete catastrophe when the food producers altogether refuse to take the depreciated paper money in exchange for their products. If anybody still believes this forecast to be the exaggerations of a pessimist, he has only to lay before himself the map of Europe. All the successive stages of the process of inflation are there represented simultaneously, England, France, Italy, Germany, Austria and Russia showing some typical milestones on the downward road to the ultimate catastrophe. No country that is gliding on this slope can feel itself safe from unexpected consequences, nor can Europe as a whole regain security and strength as long as any important part of it is still involved in this most pernicious process.

Several countries in Europe are at present in such extremely bad economic conditions that they will find it altogether impossible to restore equilibrium in their State budgets. Such countries, if left to themselves, have hardly any other choice than to go on financing their State expenditures to a great extent by artificially created purchasing power and therefore to continue the inflation of their currencies. If this is to be avoided, they must have assistance in some form. And it seems natural enough that such assistance should be given to them in the first place by relieving them temporarily from certain State services which in the hands of their governments only mean an additional and unbearable burden for their budget, but which if transferred to an international body could be brought up to full efficiency and by-and-by even be made profitable. The most important case, is, of course, that of State railways. In Germany this service is actually worked at a loss that is responsible to a very great extent for the enormous deficit in the budget. Clearly, in such a case, no help from the outside world could immediately do more for the restoration of equilibrium in the State finance of the country than a measure which would free the exchequer from the burden of the State railways.

If, by the different measures here suggested, or by other means of similar character, it had become possible for a country to reduce its State expenditure within the limits of its resources, some guarantee ought to be found that such an equilibrium should actually be maintained for the future, and that no renewed recourse to inflationistic finance should occur. The natural way to secure this end is to reserve the issue

of notes and similar means of payment to an independent institution, *e.g.*, of the type of the Bank of England, a necessary complement to such a measure being of course an effectual limitation of the credits which such an institution should be entitled to give to the government of the country. In countries where the guarantees for the strict observance of such rules were found to be insufficient, an international control of the issuing institution ought to be made a condition of any financial assistance from abroad ; for such assistance would be merely wasted charity, completely incapable of securing the economic recovery it should aim at, as long as the finance of the country were allowed to be based on a continued inflation of its currency.

A sufficient restriction of State expenditure is a necessary condition which must be fulfilled if restrictions on the capital demands of the business community are to be of any use. Indeed, if the method of creating purchasing power by inflation is left open to the government, restrictions laid upon the capital requirements of individual enterprise, *e.g.*, in the form of a high bank rate, may be directly pernicious. Such restrictions work, as is explained above, mainly as a check against the employment of the productive forces of the community in industries producing fixed capital, directing these forces to purposes of more immediate need, the chief practical result being perhaps that labour is diverted to some extent from building and constructive work to agriculture. But this process involves, of course, always a certain unemployment in these constructive occupations and a pressure on the wages in such trades. The danger is then that the government, under the influence of

false philanthropic ideas, feels itself obliged to subsidise the labourers brought under this pressure, offering them unemployment doles or starting comprehensive schemes of constructive work, as, *e.g.*, road and railway construction or house building, in order to create employment for the labourers which the restricted supply of capital has made it impossible for private enterprise to employ. The result is then only that the government spends the capital that private enterprise was compelled to abstain from spending. The total demand for capital will remain the same, *i.e.*, it will surpass the real supply of capital at the disposal of the community, and the process of inflation will continue. When this is realised, the conclusion will probably be that the restrictions laid upon the supply of capital to private enterprise have not been severe enough, and a further increase of the bank rate will be advocated as necessary. The consequence will be more unemployment in constructing trades, and new demands for government assistance. We are then in a *circulus vitiosus* which may prove extremely fatal. It is necessary that these consequences, which indeed, are not only hypothetical, but have to a certain extent already begun to show themselves, should be clearly seen before we enter upon any scheme of restricting the capital market.

X

THE PROBLEM OF DEFLATION

If we only pay some earnest attention to the serious difficulties we shall have to overcome in order to stabilise a depreciated monetary standard at about its present value, we shall immediately realise that the idea of a deflation, bringing back the value of that money to its pre-war level, is altogether Utopian. The popular belief that prices by some mysterious reason will come down of themselves to their old "normal" level is a result of the systematical fostering of false conceptions in regard to the causes of the rise of prices which has been carried on with such remarkable zeal during the whole period of inflation. There is, of course, no ground whatever for such a belief. Sometimes the hope is expressed, by people who see the influence of the great mass of money, that the general economic development will increase the genuine need for money so much as to match the present supply. This seems, however, to be a particularly vain expectation. The general rate of economic progress has been, during the half-century before the war, about 3 per cent. per annum. With this rate it would take thirty-one years to overcome a present inflation of 250 (100 denoting the normal supply of money), and nearly

thirty-eight years to meet the abundance of money in a country where the inflation has reached 300, not to speak of other countries where the inflation is much higher. Supposing that it really would be possible, by some very severe restraints on the market, to keep down the supply of money, during this long period, at its present figure, such a policy would involve a continual depression of the general level of prices by about 3 per cent. per annum. Under such prospects, however, it is obviously impossible to expect a normal rate of progress; indeed, the most probable result would be a more or less complete killing of industrial enterprise and of the very spirit of economic progress. But then the need for money, reduced to pre-war prices, would hardly ever grow up to the figure of the present supply. Clearly the policy involved in this conception of the problem of deflation can never be seriously contemplated.

Before entering upon the question to what extent a deflation might be possible or desirable, we first have to make ourselves acquainted with the nature of the means which we should have to apply in order to press down the general level of prices, and thus to raise the value of the monetary unit. This process being the reverse of inflation, it must obviously consist in restraining artificially the monetary purchasing power in the community. Two ways are conceivable for this purpose. *First*, the State can lay such high taxes upon its citizens, or take up such big loans from them that it gets hold of a sum of money greater than is required to cover the expenses of the State, and then use the surplus to extinguish a corresponding amount of monetary purchasing power, *e.g.*, by burning its own notes to that amount or repaying advances

from the central bank. But this is easier to say than to do. Considering how great difficulties a minister of finance has to surmount before he can attain even the more moderate aim of an equilibrium in the budget, and how far most European countries are from this end, it would be rather optimistic to look for a speedy recovery of the depreciated standards on this line. And, even if such a policy formally succeeded, care must be taken that the taxes or the loans did not become so oppressive as to compel the citizens to rely upon fresh advances from the banks for the payment of their obligations. And even assuming that this point were cleared, such a restrictive policy of State finance would never attain its purpose if not assisted by corresponding restrictions of the money market.

We then, *secondly*, have to take account of the possibility of enforcing deflation by a high bank rate, or by other restrictions of the lending of the banks. The restrictions must then be so sharp that a stage is reached where the banks lend less than the actual savings deposited with them, and use the rest to cancel nominal purchasing power. Such a policy would without doubt press down prices, but it would at the same time have a very depressing influence on trade and industrial enterprise. The difficulties of a prolonged application of such methods are obvious.

These being the means by which a deflation can be carried through, it seems clear enough that the practical possibilities of the programme of deflation are rather narrow, and that a radical realisation of this programme will, in reality, show itself very little desirable. A prolonged period of falling prices and consequent general economic depression will never

be accepted as a wise device of deliberate economic policy.

Further, the question arises whether it is in itself desirable that the purchasing power of money should be raised to something like it was before the war, or, indeed, even be substantially increased. From the point of view of State finance, the answer to this question is clear enough: a considerable increase of the value of the monetary unit in which the debts of the State are contracted would in most cases make the State definitely insolvent. Already for this reason a considerable deflation is practically impossible, and cannot be seriously discussed. It would, of course, also cause insuperable difficulties to private debtors who have entered into their contracts during the latest period of depreciation, or, more accurately expressed, at a value of the monetary unit lower than that to which it should be restored.

Still, a process of deflation within more narrow limits can be taken into consideration, and may in some cases prove desirable. The prices of commodities have not adjusted themselves yet in any uniform way to the rate of inflation, nor have the prices of services; on the whole wages probably lag behind. A stabilisation of the monetary standard may reasonably take account of these circumstances, and choose the new value for the monetary unit somewhat below the figure representing the latest rate of inflation. However, it seems hardly advisable to enter upon any deflation scheme which would involve a reduction of the general level of money wages; for every such endeavour would without doubt lead to social unrest, and in this way make harm out of all proportion to the advantage it could bring.

The choice of the value at which to stabilise the monetary unit will probably everywhere be put into connection with the question of resumption of gold payments. Owing to causes which have been explained under (III), gold has lost a considerable part of its pre-war value as against commodities, prices of commodities having risen in a gold standard like the dollar to about 250 against 100 before the war. In a country where the depreciation of the monetary standard has not gone much further than this depreciation of gold, it will seem very desirable to uphold the old parity with gold, *i.e.*, to make the notes redeemable in gold at their face value; and this will then be possible by a comparatively small reduction in the supply of the means of payment. A deflation within such reasonable limits is, *e.g.*, doubtless possible in England, where a reduction of the general level of prices by about 20 per cent. would probably be sufficient to establish parity between the paper pound sterling and the gold sovereign, and therefore also to bring up the dollar exchange value of the pound sterling to its old parity. But even this moderate aim cannot be attained without a deliberate policy based on a thorough scientific analysis of the problem and ready to apply the right measures and to face the sacrifices which they involve. Formal decisions establishing a maximum for the issue of currency notes, or even reducing this maximum gradually, will not be sufficient. A reduction of State expenditure, bringing it down to what the people can and will actually pay out of their current income, is necessary. And a restrictive bank policy with a high rate of discount is also necessary. Only such measures will give full effect to the legal restrictions of the note

issue. Increased gold holdings cannot of themselves facilitate the resumption of gold payments, but the full discussion of this point must be reserved for a following paragraph.

Everybody who has given some attention to the problem of resumption of gold payments in the case of the United Kingdom will immediately realise that the corresponding aim is altogether out of reach for countries with an essentially more depreciated currency, say, for France or Italy. The French franc and the Italian lira have now hardly the half of their old value in comparison with gold, and very serious efforts would probably in both cases be required in order to stabilise the currency at half its old gold parity. Under such circumstances, it will be necessary to study the problem of stabilisation of the monetary standard very carefully before entering upon any decision as to its future relation to gold. And it should thereby constantly be kept in mind that it is far more important, and for the present time urgent, to cease inflation, perhaps even to carry through a certain amount of deflation, and thus to stabilise the internal value of the money in comparison with commodities than to try to fix a definite relation to gold. When the time has come to take up this latter problem, it will be easier to survey all the circumstances affecting it.

For countries with much more inflated currencies, the problem of stopping further inflation is generally so troublesome and still so far from its solution that the question of deflation, or of the ultimate value to be given to the monetary unit, can hardly be raised yet. It is important, however, that the whole world should see that further steps on the road of

inflation can practically never be retraced. The longer the stabilisation of these monetary standards is delayed, the lower will be the values that they will get ultimately.

It is often thought that seriously depreciated monetary standards must be abandoned as altogether unfit for their function. This is not the case. If only the value of the unit has been stabilised, and the prices of all commodities and services have had time to adapt themselves to this new unit, the new money will serve just as well as the old did. Perhaps the new unit will be thought to be too small, and it may seem desirable to exchange it for a unit, *e.g.*, ten times larger. Such a measure would leave the continuity with the old standard essentially undisturbed, and would therefore not be a real abandonment of the old standard.

XI

THE STABILISATION OF INTERNATIONAL EXCHANGES

THE stabilisation of the internal value of money, *i.e.*, of its buying capacity against commodities, is by far the most urgent object to be pursued by the monetary policy which the different countries now have to enter upon. Between two nations which have attained this end a new normal rate of exchange will establish itself, this rate being determined by the quotient of the purchasing power of money in the respective countries. As freedom of trade and general confidence are gradually restored, the abnormal deviations of the exchanges described under (VI) will be more and more restricted, and will ultimately disappear, and the actual rates will tend to coincide nearer and nearer with the normal rate.

The new normal rates of exchanges may be, and in many cases certainly will be, very different from the pre-war parities. But this is a matter of secondary importance. The essential thing is that there should be any normal rates and that these are kept as constant as possible. For this end no other measure is wanted than the stabilisation of the internal value of each monetary standard concerned.

That this stabilisation should be achieved as generally and as early as possible is obviously a common interest

for all nations. For as long as some standards have a fluctuating internal value no stability in the exchanges between these standards and those of other countries is conceivable. It is therefore against the common interest that any country should be allowed to go on inflating its currency or left in such circumstances that such inflation is practically unavoidable. But it is also, and for the same reason, against the common interest, that any country should try, by a continued process of deflation, to go on raising the internal value of its monetary standard, *e.g.*, to something like what it was before the war. For reasons that have already been set out, it is not probable that such a policy would ever succeed. But it is better that this should be recognised, even officially, in order that the world could begin to reckon with the standard in question as having a definitely fixed value.

We here touch upon a very essential side of the whole problem before us. The world is suffering, at present, most severely from the uncertainty of the internal value of money in the different countries, and from the incessant fluctuations of the rates of exchange. Production which involves investment of capital becomes very hazardous when the future value of money is quite uncertain. And the same holds true in regard to every international business transaction as long as nobody can tell, not even approximately, what the rate of exchanges will turn out when the transaction is completed. Under these circumstances, the revival of productive activity and of international trade is very much hampered and delayed, to the greatest material detriment to the whole world, and, indeed, to the most formidable danger for the preservation of civilised society.

In meeting these difficulties, our first aim should be to create stability and security. Every country should decide, at the earliest possible date, what internal value it is going to give to its money, what amount of deflation it thinks proper and possible to attain, or perhaps, in the worst cases, what limit it thinks it can set to further inflation. And the policy thus determined should be made public in order that people should know what they had to reckon with. Internally, this would make an end of all talk of a restoration of the pre-war level of prices, and definitely do away with all hopes and all fears attached to this second price-revolution; and the trust in the future stability of the monetary standard would afford the basis for a new development of economic life within the country. Externally, likewise, the trust in the future stability of the exchanges would give a powerful stimulus to international trade. A fixed policy for the stabilisation of the most important standard of the world would be of great value for the smaller countries anxious to adapt their standards in some definite ratio to the leading standards of the world's trade. The public announcement of a definite monetary policy would in itself be a very wholesome measure, obliging the government and the issuing bank to an earnest and comprehensive consideration of the whole problem, and after that binding them morally to a stern fulfilment of the policy decided upon.

Of course, it would be very useful if the general principles upon which to act in these matters could be agreed upon internationally. A stabilisation of the internal values of the monetary units can only lead to a stabilisation of the purchasing power parities

between these units. But, as has been shown under (VI), deviations from these normal rates are possible, and are actually a considerable grievance in the present state of the world's monetary affairs. The problem of stabilisation of exchanges includes, therefore, necessarily a scheme for preventing such abnormal deviations.

When a country, as is the case with Germany, has a large floating debt abroad, in the form of bank-notes or other notes, or debts on current accounts of the banks, a preliminary measure must be to exchange this debt against a funded loan. For, as long as a floating debt of such a character is allowed to exist, it tends to depreciate the money of the country on the international exchanges beneath its purchasing power parity; and this pernicious effect will then lead the country to extraordinary measures for protection of its internal market against an overwhelming buying capacity. A great consolidation loan for the redemption of the outstanding means of payment in German marks is therefore a first step necessary in order to bring the German exchange problem into a normal condition. The loan should, of course, chiefly be subscribed by the present holders of German marks, who would have an inducement to do that in the probable rise of the German exchange which would follow.

There are possibly some other countries with outstanding debts of the same nature, though not at all on the same scale. Similar funding loans should then be issued by them and taken in exchange by the holders of the floating debts.

Next, some means have to be found in order to prevent the practice of selling out one's own currency in order to acquire buying capacity in foreign countries.

This is a most delicate problem, which hardly can be solved by any direct prohibitions. Although international agreements of a suitable kind ought to be of some use, the most promising way seems to be to open possibilities for a country in distress to obtain, in the normal way of loans, such credits as are absolutely necessary.

Assuming these points satisfactorily settled, the problem of preventing abnormal deviations of the rates of exchanges becomes essentially a problem of restoring freedom and equality in international trade. The first condition to be fulfilled is that the present differentiations of prices in favour of the inland market or between foreign buyers of different nationalities should be completely abolished. The possession of a certain sum in the currency of a country must represent the same right to buy on the internal market of the country, irrespective of the nationality of the possessor of the money or of the destination he wishes to give to the commodities bought. If this elementary principle is disregarded, it is vain to expect an international valuation of the currency in accordance with its internal purchasing power.

The second condition—which is, in fact, nearly connected with the first—is that one-sided hindrances against trade between one country and another should as far as possible be abolished. Practically this claim involves that export—or import—prohibitions should be done away with when not absolutely wanted for the protection of scanty supplies of commodities of primary necessity. At any rate, no prohibitions should be retained only in order to serve as a basis for a licence system calculated to be used for imposing special burdens on trade.

These two conditions require the sacrifice of a policy trying to make profit for the home country at the cost of other countries. Such practices have long ago been rejected as detrimental for the trade between nations, and, therefore, in the long run, for the home country too, and it is much to be regretted that they should now have been taken up again. Against the advantage that may be won for the home country by any measure of this kind, there is always the disadvantage of other countries applying the same policy. And then there is the general disadvantage for all countries of a hampering of trade and of a disturbance of the international exchanges showing itself in abnormal deviations from the purchasing power parities. If people could see all these consequences of what might be styled a national profiteering policy, its popularity would certainly very soon dwindle away.

An international agreement to discontinue all measures of this kind would do very much for restoring trade and, at the same time, for securing stability to international exchanges.

The measures here proposed are necessary conditions for a real solution of the very intricate problem of exchanges now before the world. But they are also sufficient. The world's trade can be carried on at any parities between the different monetary standards; the only essential thing being that the actual exchanges should remain steady in the neighbourhood of these parities.

It is often believed that the recovery of trade which is now so urgently needed could best be furthered by the establishment of an international standard of money. This is obviously a mistake; for if every

country should retain its own currency, the international money could only fill the function of an intermediary link in international payments. But there is no need whatever of such a link. As long as the international value of a currency continued to fluctuate, the exchange between this currency and the international standard would fluctuate too, and the introduction of this standard would not have brought us a bit nearer the stability of exchanges, but only created a new and unnecessary complication. The other alternative would be that several countries with bad currencies should altogether abandon their old standard and introduce the new international standard instead. This is, however, an extremely difficult operation, involving the most delicate problems of conversion of the old money to the new. And if a country should really wish to abandon its old standard it could just as well introduce one of the existing standards, *e.g.*, the dollar; and then there would be no need to create a quite new standard for the purpose. The popularity of the idea of an international standard seems very much to be based on the belief that the whole question of exchange would be eliminated by the adoption of a common unit of money. The experience of the last years has, however, demonstrated the futility of this belief to the full. The problem of keeping a stable exchange between two countries remains essentially the same whether the countries have nominally the same unit of money or not. And a country making the dollar, or even a new international unit, the basis of its monetary system would not thereby have in the least secured itself a stable exchange as against the dollar or the international standard.

Under such circumstances it is difficult to see how a country like Austria could gain any real advantage by introducing beside its present money a new standard specially intended to serve as a basis of its foreign trade. The whole problem of the exchange value of the present Austrian money would remain substantially the same, though it had been formally transferred to an internal question. And then there would be the fresh problem of the exchanges between the new standard and those of foreign countries; the simple device of making the new standard a "gold standard" may perhaps give this problem an air of simplicity—inducing people to overlook its real difficulties.

If we analyse the different schemes put forward in favour of a new international standard, we shall almost invariably find that they involve the creating of new masses of paper currency, and that they, in fact, derive a great part of their alleged usefulness from the fresh purchasing power, which in this way is put at disposal for purposes thought to be of primary importance for the world. Ultimately, then, such schemes unveil themselves as a policy of continuing, on a world-wide scale, the process of inflation hitherto carried on as a national concern. But that this cannot be the solution of the world's present monetary difficulties seems clear enough.

XII

THE GOLD QUESTION

Whatever may be said, from a theoretical point of view, against gold as a standard of value, particularly with regard to the violent fall in the value of this metal which, as shown under (III), has taken place during recent years, it seems pretty sure that most countries look forward to the restoration of a gold standard and the resumption of gold payments as the real rescue from the hopeless muddle of the present paper-money system. We must reckon with this desire as a matter of fact, and we have, then, in the first place, to take account of its influence on the question of fixing the present fluctuating monetary standards at some definite values.

The value of gold as against commodities having been reduced to something about 40 per cent. of what it used to be before the war, the resumption of gold payments at par will be within practical reach of those countries where the depreciation of the monetary standard has not gone much further. The desire to avoid a formal reduction of the value of the monetary unit, and to be able to redeem notes at their face value, thus upholding perhaps, in the eyes of the public, the fiction of an undebased standard, will certainly in such cases call forth the most serious efforts

for the necessary amount of deflation. But a country with still more inflated money will have to give up even thinking of a redemption of its notes in gold in conformity with the old standard. Such a country must first, as stated above, attain a certain stabilisation of the internal value of its money. When this value is sufficiently fixed and foreign exchanges have settled themselves according to it, the country may take into consideration whether a new gold parity shall be given to its monetary unit.

The United States having already resumed gold payments, the dollar may be taken henceforth to represent gold. The problem of the restoration of a gold standard will therefore practically take the form of the problem of stabilising the dollar exchange at some definite figure. England and some Continental countries will certainly do their utmost to restore the pre-war parity of their currency with the dollar. Other countries with much more depreciated money will have to relinquish this aim and to choose a new parity with the dollar, concentrating all their energies upon keeping their money in that parity for the future. Now the problem of stabilising the dollar exchange, in either of these aspects, would be aggravated if the United States increased the value of their money by a process of deflation. This was actually planned at the middle of 1919 when a great campaign against high prices was started. But relying upon the usual popular means, regulation of prices and persecution of profiteers, the campaign had naturally no success; in March, 1920, the general level of prices in the United States had risen to 253·0 against 217·0 as the average for 1919. Disagreeable as this development may have been to the United States, it has very considerably

facilitated the problem of restoration of the pre-war dollar-exchange of the pound sterling and of some of the better Continental currencies. It is now clearly in the interest of all countries endeavouring to stabilise their dollar-exchange that the United States should not enter upon any monetary policy effectively raising the internal value of the dollar. In fact, the problem of stabilising the world's exchanges being in its nature an international problem, it is desirable that one country should take the lead by fixing the internal value of its money, and it seems natural that this country should be the United States.

In the same manner, it is of great interest for all countries striving to restore a definite parity with gold, that the value of gold as against commodities should not be raised, and that, when the new parities once have been settled, the value of gold should remain as constant as possible. Though the enormous fall in the value of gold since the beginning of the war has certainly been a very injurious process, the inverse process of raising the value of gold would probably be still more disastrous. For the gold countries it would mean a prolonged process of deflation with all its pernicious effects of trade and enterprise and on the financial burdens of the State. For other countries it would seriously aggravate the restoration of a pre-war gold parity or the maintenance of a new established gold parity.

It seems then, in the first instance, to be a common interest for the world *to prevent gold from rising again in value.* The present low value of gold is mainly the consequence of a relatively diminished demand for gold for monetary purposes. The actual circulation of gold is very generally abandoned, and the

great central banks have reduced their claims on relative gold-coverings considerably. Should a return to pre-war conditions in this respect set in, the inevitable consequence would be an enhancement of the value of gold. To avoid this, it is necessary that all countries should abstain from measures for reintroducing an actual gold-circulation and content themselves with their present standard of gold holdings as basis for their paper-circulation. Countries which are in a position to draw gold to themselves from the rest of the world should abstain from doing so. Thus the stabilisation of the value of gold will clearly require, in the coming years, a close co-operation of all countries. Perhaps it will be possible to come to some international agreement in this matter. For instance, some measures in order to draw gold coins out of actual circulation, including eventually the stopping of all further coinage of gold, would be a natural object for such an agreement.

The present monetary problems of Great Britain throw an interesting light upon the whole question. If the prescribed limitation of the issue of uncovered currency notes to a maximum of £320·6 millions is to be carried through, as the acquisitions of gold by the Bank of England seem to indicate, by aid of an increase in the note circulation of the bank, no rise in the internal value of English money will be achieved, but the necessity of acquiring more gold will strengthen the world's demand for this metal and help to enhance its value. If other countries should follow the example, this enhancement might become very embarrassing. On the other side, if England should at once throw on the world's market a hundred million pounds' worth of gold, the result would be a very sharp fall

in the value of gold, perhaps sufficient to restore the old gold-parity of the English money. And if a strong combination of smaller countries acted in the same way, the result on the world value of gold would be similar. Such policy is, of course, not to be recommended because of the violent disturbance it would cause. But a consideration of the effects is useful, as it shows most clearly the futility of the usual policy of preparing a restoration of the gold standard by trying to acquire as much gold as possible.

The second chief problem of the world's gold question is to secure for the future as far as possible a *stable value of gold* relative to commodities. The withdrawal of gold from circulation and the disappearance of all definite standards of gold-cover have in a most serious degree impaired the stability of the value of gold. If gold is to be used henceforth as a monetary standard, it is, therefore, necessary to take special measures for stabilising the value of the metal. As these measures, which would mainly consist in the establishing of appropriate and stable principles in regard to the gold-holdings of the central banks, naturally must be of an international character, we have to do here with a problem where a co-operation between all countries is particularly required.

The stabilisation of the value of gold involves, however, special difficulties arising in connection with the production of the metal. If we have a stabilised monetary demand for gold, we must, of course, have an annual production of gold corresponding to the general rate of economic progress of the world, and, in addition, sufficient to cover the yearly waste of gold. This normal annual demand for gold amounted, during the period 1850–1910, on an average

to about 3 per cent. of the total accumulated stock of gold in the world at the time. Of this sum 0·2 per cent. covered the loss of gold and 2·8 per cent. was added to the world's stock of gold. Thus the stock of gold, and therefore, also, the annual addition to it, increased on an average by the yearly percentage of 2·8, and that with the result that the value of gold was the same at the end of the period as at the beginning. Assuming the same rate of progress in the years before us, we should need at present an annual production of gold of about £100 millions, increasing in subsequent years at the rate of 2·8 per cent. yearly.

In 1915 the world's production nearly reached this sum with a figure of £96·6 millions. But the rise of prices of commodities in terms of gold units has hampered the production and brought it down considerably below the figure attained in 1915. In the Transvaal the falling off of the production has not been very marked, but still a reduction from the maximum of £39·5 millions in 1916 to £35·8 millions in 1918 and a somewhat lower figure in 1919 has taken place. Much greater has been the decline in the gold production in the United States, where a maximum of 101 million dollars was reached in 1915, but where the production for 1918 was only 68 million dollars and for 1919 not more than 58·5 million dollars. The total for the world's production in 1919 is estimated to be not more than £75 millions.

The production is consequently at present not sufficient for a normal increase in the world's stock of gold. As the necessary annual production of gold would, under the assumed rate of progress, in ten years be £132 millions and in twenty years £174 millions, the danger of a quite insufficient supply of gold is

much more imminent than seems to be generally recognised. Another factor is working in the same direction. Gold being the only commodity which has not risen in price while in countries with an effective gold standard other prices have been doubled, and the general level of incomes has been raised in the same proportion, it is only natural that the demand for gold as a material for articles of luxury should have increased substantially. It is also known that the use of gold in the arts is growing rapidly. This consumption threatens, indeed, to absorb a large part of the diminished annual production of gold. What is left for monetary use will then be very insufficient for the necessary regular increase in the world's monetary stock of gold. This deficiency must result in a progressive scarcity of gold and a consequent continued rise in its value. This result could be avoided only if new goldfields were discovered and developed in the proportion necessary for a normal supply of gold. But leaving such a possibility out of consideration and assuming the production of gold to remain about constant, we have to face a growing scarcity of gold and a continued depression of prices.

It will therefore probably be necessary not only now to prevent the monetary demand for gold from resuming its old dimensions, but also to regulate henceforth this demand with a view to reducing it gradually, as the growing scarcity of the supply of gold may require. If we further take into consideration the possibilities of changes in the conditions of gold-mining, we shall find that the scope for this regulation of the monetary demand for gold may easily be considerably widened. Thus the task may seem to involve great difficulties. But if we are not prepared to abolish at once and for

ever the use of gold as a standard of value, we clearly must do something to stabilise the value of gold, and this is certainly not possible without a rational regulation of the monetary demand for gold.

In addition, we may perhaps apply other means, viz., first, suitable restrictions of the industrial demand for gold; and, second, a policy aiming at checking the demand for gold from the Far East by developing Asia's needs for more useful European products.

XIII

RECONSTRUCTION

It is often contended, and still more often thoughtlessly repeated, that the present miserable situation of Europe is the result of the war. This is not true. Certainly the war has left Europe in difficult economic conditions. But the serious aggravation of the difficulties which have taken place since the war, and of which the enormous further deterioration of the monetary system is only one of many witnesses, is simply the result of an unwise policy, singularly incapable of looking upon the problems before the world from an economic point of view. The new conditions created have been of such a character as to make a revival of economic life in Europe to a great extent impossible. New political boundaries have been drawn up on the map of Europe, cutting off old lines of economic communication established by centuries of work and organisation, and, like plants with their roots cut off, old centres of economic life have been left to die. The principle of nationality has been applied with a stress quite incompatible with modern economic conditions, requiring a large home market and a wide area for the free movement of internal trade. Whatever may have been the political merits of this policy, its economic consequences have

shown themselves to be disastrous. The defeated nations have also been shut out, in the most fatal way, from trade with the outside world ; and as the life of these nations was so constructed as to depend to a large extent on foreign trade and particularly on exchange of industrial products for food and raw materials, their chance of recovery was thereby reduced to something very near to hopelessness. In this policy protectionist interests, trying to exploit political feelings, to establish private or national monopolies and to use a unique opportunity to get rid of a troublesome competition, have had an influence which in the long run will show itself to have been adverse to the real welfare, not only of the world as a whole, but even of the nations engaged in the service of such interests.

One and a-half years after the Armistice, the economic situation of Central and Eastern Europe is much worse than it ever was during the war. As a matter of fact, it has become impossible for the present population of this area to live within its boundaries. It is not allowed to come out freely. A reduction of the population to that percentage that could subsist on the national resources is impossible. And the result is that the present population, trying to live on a half-standard, is gradually but fatally deteriorating in physical and moral force, and that the growing generation, weakened from the outset by starvation and disease, is doomed to an extremely miserable and ineffectual life. A productive organisation which used to set a good standard for the world is quickly deteriorating, and a highly disciplined social organisation is dissolving and sinking down into a state of continual unrest and even partially into pure anarchy.

No scattered humanitarian efforts can bring real help in this situation. Not even the best-organised measures of subvention can do much more than prolong this existence on the margin of death. What is required is a thorough re-modelling of the conditions under which these peoples have been left to live. This does not necessarily mean a revision of the treaties of peace, which partly is now impossible, and partly would take too much time. But it means that those who have the power should begin to use it with a clear understanding of the nature and the seriousness of the situation before them. Indeed, this situation is not merely the concern of some defeated Powers. The process of economic deterioration and social dissolution going on within them cannot be confined within their boundaries. The productive capacity of an essential part of Europe cannot be seriously impaired without consequences for the rest of Europe; and the disease of social unrest and disintegration is dangerously contagious. These influences have, in fact, already made themselves felt: the unexpected, but by now unmistakable, deterioration of the situation of some of the victorious countries after the Armistice speaks clearly enough to everybody who wishes to understand. Europe is necessarily in important aspects a unit. It is completely vain to try to suppress a part of it and believe in a future for the rest.

The general pre-requisitions for any positive work of reconstruction seem to be, essentially, the following:—

First, real peace must be established, meaning not only the cessation of actual hostilities, but, indeed, sincere, friendly co-operation of all nations for the recovery of the economic life of the world.

Equally needed is internal peace within every nation, meaning again sincere co-operation of the different classes and the definite abandonment of the idea that progress can in any way be furthered by attempts to destroy the principle of government.

The establishment of sound monetary systems is a further condition which must be fulfilled to make economic recovery possible, but which, as shown above, can itself only be attained if the world reverts to sound economy in all respects.

The economic disadvantages of the many new boundaries which the political re-modelling of Europe has drawn up have to be neutralised by the widest possible application of the principles of free trade between the different political units. No narrow separation can be tolerated in this respect. Traffic and intercourse between and through the countries must be freed from all unnecessary restrictions. The fulfilling of this programme, which has to be worked out in distinct rules, must be made an absolute condition of any outside assistance to these countries.

Then there is the case of the trade relations between Central Europe and the outside world. A country organised for an export of manufactures cannot live without free access to the world's markets. And of course it is also in the interest of these markets that they should be free to buy where they think it advantageous. An economic recovery of the world will be best secured by the greatest freedom of the world's trade and by the complete abolition of every form of discrimination between products in regard to their country origin. This involves that even every private agitation against the products of any particular country should be stopped as foolish and

altogether opposed to the efforts for a revival of the world's prosperity.

The other side of this case is, of course, that all countries, and among them even the defeated Powers of Central Europe, should be allowed to buy raw materials and food on equal conditions in all markets of the world. It was generally recognised, before the war, as a wise rule that the possession of colonies or dependencies should never be used for establishing economic monopolies. This principle of the Open Door becomes, obviously, still more urgent when such possession has been concentrated on a few Powers. The wider the areas are which are laid under the control of one empire the more necessary is it that this control should be regarded as a function of a trustee, having to serve the interest of the world at large. In the case of mandates under the authority of the League of Nations, this principle is fundamental.

The programme of securing the greatest possible freedom to international trade does not, of course, involve any interference with taxation of consumption. And particularly a country in serious distress should in no way be hindered from taxing imports of luxuries or even from prohibiting such imports. Neither is it necessary to interpret the programme so strictly as to exclude a customary moderate protectionism.

Finally, it is required that the principle of private property should be universally recognised, and that in this respect an equal treatment of the subjects of all nations should be guaranteed.

Obviously these pre-requisites of reconstruction are to a certain extent of such a character that they cannot be fulfilled immediately, and their realisation can be expected only during the progress of the work of

reconstruction. But much could be done at once to assure the world that it is on these lines and in this spirit that the world is going to be governed in the future. And that is essential.

When we come to discuss the positive measures of reconstruction that are likely to be the most effectual, we have constantly to have in mind that the aim of such measures must be the development of the production and of the trade of the countries at present in need of help. Advances of food, as well as those of raw materials, must be looked upon as means to revive their economic life, and to enable them to become, at the earliest possible date, positively useful members of the world's trading community. But if this is our sincere aim, it is obvious enough that we shall have to do away, unhesitatingly, with all endeavours to suppress the same countries or keep them back in their economic development.

Until a regular exchange of commodities on the basis of payment in money can be arranged, it may prove useful to send materials to be worked up in the distressed country, and take the finished product back, paying for the work done by a part of the materials or otherwise. The method requires a mortgage right in the materials, extending to the products made of them ; such rights must then be recognised not only by the legislation of the country itself, but also by the Powers under the control of which the country may be. As a provisional measure, it may perhaps also be useful to arrange clearing centres for the direct exchange of commodities ; but the efforts in that direction seem hitherto not to have had very satisfactory results.

Among the positive measures for reconstruction of the economic life of Europe, the organisation of trans-

port has a very prominent place. An important part of this problem has already, as is well known, been taken up under the auspices of the League of Nations. But the problem has other sides deserving attention. A country in the position of Germany, depending so essentially on sea transport, ought not to be deprived of tonnage to a degree which, looked upon from the point of view of the world's economy, would be judged to be uneconomical.

And then there is the great problem of railway transport in Central Europe, including the eastern States on the Russian frontier. If the whole railway system of this area could be brought under the control of some central body with the programme of securing equal treatment to all traffic, of putting the economy of the railways on a paying basis and of supplying them with the capital most urgently needed for their efficiency, probably more would have been done to promote reconstruction than is possible in any other way. The capital borrowed for this purpose would serve the economic recovery of the countries in question in the most effectual manner, and it would be backed by the best security obtainable, and have the best prospects of being repaid with interest. These advantages would, presumably, make it easier to raise capital abroad for such a definite purpose than for any assistance to the governments of the countries for reconstruction in general. At the same time, the work done for increasing the effectiveness of the railway system would be a pioneer work for development of industry and trade and would therefore probably pave the way for fresh supplies of capital to private enterprises.

Some help towards reconstruction of distressed

countries has without doubt been brought by the purchases from abroad of industrial concerns or of shares in public companies of those countries. When the buyers take a sincere interest in the development of such enterprises and use their profits for further investments in them, such purchases seem on the whole to be for the good of the economic recovery of the country. But occasional purchases of houses, shares or other property probably only furnish the selling country with money for paying for current consumption.

There are, of course, serious questions of reconstruction even in other countries, such as Italy, France and Belgium. The solution of these questions depends to a great extent on the fulfilling of the general conditions of the world's economic recovery, as stated above. The world's capacity of supplying these countries with capital will, at any rate, essentially be determined by its economic development in the coming years. A more complete discussion of this question must, however, be reserved for the next paragraph.

Taking a broader view, and looking upon Europe as a whole, we have to recognise that the problem of reconstruction is not merely, or even principally, a problem of physical reconstruction of what has been destroyed during the war or of a restoration of European production to what it used to be before the war. The position of Europe in the world's economy has changed. The world suffers unmistakably from a relative scarcity of food and of certain raw materials supplied by non-European countries. This means that the production of the world must be directed, to a greater extent than it has been hitherto, to the production of such food and materials. And this

again requires a certain adjustment of the distribution of the world's population. Europe is over-populated in the sense that it would be more economical for the world at large if a part of Europe's industrial population could be transferred to other continents, where it could be employed in production of food and materials. The problem of reconstruction before us cannot be stated truly without due regard to this situation. It would be a mistake, from the point of view of the world's economy, to employ the whole available surplus of the world's productive powers for European reconstruction in a narrower sense. A part of this surplus can be used, with greater and more immediate advantage, for the development of other countries, with the aid of superfluous European labour. If Europe fails to recognise this truth, it will be disagreeably reminded of it by the rates of interest rising in other parts of the world to a level far above what Europe thinks a proper level for itself.

XIV

INTERNATIONAL LOANS

It is often believed that the problem of reconstruction is essentially a question of supply of capital from abroad, and that this capital can be taken from the accumulated wealth of other countries. This is not so. Reconstruction—in the wide sense we have taken the word—is in its nature primarily a revival of work within the distressed country, involving restoration of order, of intensity of labour, of organisation and of private enterprise. To help this work, a supply of means of subsistence and of materials from the outside world is required, and as this supply cannot immediately be paid for by a corresponding export, it has to be made on credit. This is the real meaning of a "supply of capital from abroad." It is then also clear that this supply cannot be taken from any accumulated wealth of the lending countries, but has to be provided by their current production. In order to do that, the lending countries must have a surplus of production over their consumption and their own needs of fresh capital. Out of such available savings, produced day by day, loans for reconstructive work can be made, but from no other source.

True, during the war, some neutral countries were pressed to give loans beyond this limit, but this meant,

as shown above, the creating of an artificial purchasing power leading to inflation of the countries' currency and to enforced privations of whole classes of their population. This, of course, cannot be repeated now. No country should be expected to furnish loans, driving itself to further inflation. The loans for the reconstruction of the world's economic life on a sound basis must come from a sound source; and this can be no other than deliberate savings.

In addition to the loans representing material assistance, help can, of course, be given to distressed countries by relieving them—temporarily or definitely—from obligations of paying interest or capital to other countries. In cases of serious distress some measures of this kind seem to be necessary in order that assistance for actual reconstructive work shall be possible. In the following we shall leave such postponing or cancelling of claims out of consideration, and the term "international loans" will then have to be understood as meaning a real supply of fresh capital.

Now, if international loans can only be made out of real daily savings, we shall obviously have to abandon altogether the fantastic ideas of huge world loans, sufficient to make up at once for all damage caused by the war. We must accustom ourselves to look upon an "international loan" as merely a form for financing an export surplus from the lending world to the borrowing. We shall then have less difficulty in realising that there are definite limits to the amounts of such loans which can possibly be raised. There is at present a great scarcity of capital in the world, showing itself in unusually high rates of interest in all countries where the rates are not artificially kept

down by a falsified money market. This scarcity means that the daily supplies of fresh savings are insufficient to meet the enormous demands for capital. It is therefore necessary to reduce these demands and only satisfy the most important among them. In addition, everything should be done to increase the amount of savings.

Given the amount of savings, new claims for capital can obviously only be satisfied by putting aside purposes for which this capital would otherwise have been used. Big loans to distressed countries necessarily involve that the lending country should sacrifice plans for development of industry and transport or restrict their house building. This can, of course, only be expected when it is felt that the savings thus made free are turned to a still more important and urgent use. A natural expression for the higher importance of the borrowers' needs is that a higher rate of interest is offered. And it certainly cannot be expected that countries where the scarcity of capital makes it necessary to pay 7 or 8 per cent. for urgent developments of railways or industrial undertakings should restrict their capital market still more in order to supply capital to a country with a much lower level of interest —except, of course, when it is done for purely humanitarian reasons. Rates of interest have generally been higher in America than in Europe, and this was a natural thing as long as America was a borrower in Europe. Now the reverse is the case, and European countries looking for capital supply from America have to accustom themselves to American rates of interest.

If, however, such high rates of interest are to be paid for reconstruction loans, the imperative need for

a very careful scrutinising of the use of them becomes apparent. The distressed countries have to recognise that only the most urgent needs of reconstruction can be satisfied in the immediate future. And naturally, then, such use of capital must be preferred as is most immediately remunerative. It is impossible to make all reparations at once. Very much of what might seem desirable to do must be postponed. On the other side there is in Europe certainly a great amount of work of reconstruction which on purely economic lines would justify the necessary expenditure of capital in the most immediate future for the simple reason that there is hardly any more profitable use of capital than setting economic life going again where it has come to a standstill.

In a period of such urgent need for capital, it is of course highly desirable that the amount of saving in the world should be increased to the utmost. This not only involves a general restriction of unnecessary consumption and the abandonment of showy luxuries, private and public, very inappropriate at such a time as this, but also that the greatest efforts should be made to increase production. To make it possible to give effective help to the distressed countries, the whole economic life of the world has to be brought up to the highest standard of efficiency. But the first condition for this is the immediate resumption of peaceful intercourse between all nations. Countries anxious to get assistance in the form of international loans should realise that it is in their own interest to do their utmost to favour such a development.

In addition, such countries ought to pay some attention to the interests of the lenders. These

interests are largely concentrated on the restoration of production and of trading possibilities in Europe and on the establishment of stable political and social conditions. Lenders who take a broad businesslike view of the problem of financing reconstruction will wish to see their way to a material result in the form of the resumption, at the earliest possible date, of a profitable exchange of commodities with a Europe of high productive capacity; and will, therefore, naturally ask for guarantees not only that the money lent will really be used for such purposes and not for any display of military power, but also that the borrowing countries earnestly set themselves to work for their own economic recovery, and sincerely co-operate in the recovery of other countries, in any way dependent upon them. Surely those countries which are most willing to meet these requirements are most likely to get any financial assistance from abroad. But it should never be forgotten that there is a solidarity between all necessitous countries in so far as assistance from the outside world is dependent upon a *general* restoration of sound conditions.

The problem of loans for reconstruction is in many ways interwoven with the indemnity question. First, it must be very difficult to raise any considerable sums abroad for the economic restoration of Germany as long as there are no sufficient guarantees against such loans or their fruits being prematurely absorbed for indemnity payments. There is obviously a need for some postponement of indemnity claims until the loans for restoration of economic life in Germany have achieved their end to a reasonable extent; and clearly some preference has to be given to loans

furnished to help a ruined debtor to his feet and thus to make him able to pay.

It is also important that the obligations of Germany under the title of indemnity should be fixed. This involves that some scheme for yearly payments for a definite period should be fixed in relation to Germany's capacity to pay. But the question how such payments are actually to be made must be carefully looked through; the usual fault of talking of payments as merely figures is dangerous and must be avoided. Germany's capacity to pay is in itself an undetermined question as long as the way in which Germany is going to be treated is not clearly decided upon. Had everything been done, immediately after the Armistice, to revive German industry and trade, Germany would certainly have been capable of paying, during a period of years, a very substantial sum. On the other hand, if the victorious Powers think it more in their interests to crush Germany economically, they will have no difficulty in doing that so thoroughly that Germany's capacity to pay further indemnity will be practically nil. If between these two extremes a middle way is to be taken, it is all-important to know precisely which. A definite answer to this question is of the greatest interest, not only for Germany, but for the Powers claiming indemnity, and, not least, for the lenders who may be called upon to give their money to the task of restoring soundness and effectivity to European economic life. In the question of indemnity as in that of international loans, it is essential that it should be generally recognised that the money which can be expected to come forward has to be taken out of future income, not of any accumulated capital, and that income

represents necessarily the results of production and trade.

It is often believed that a fixed sum of indemnity could be discounted and thus turned into immediately available money. This would involve that lenders could be found willing to offer an international loan on the security of the indemnity. There would perhaps be something to say for such a plan if full guarantees were given for the free economic development of the country responsible for the indemnity, and if a great lending country—say, for instance, the United States—on such ground could see itself reasonably secured of compensation, not only for the indemnity loan but also for the vast sums it necessarily would have to invest in the debtor country in order to develop it up to its highest capacity. As a matter of fact, however, the prospects of a solution of the question on such lines are practically none. For private lenders without any such guarantee it would clearly be bad business to discount the indemnity, thus relieving the countries claiming indemnity from all anxiety as to the economic future of the debtor country, while the latter would remain under the military, and therefore also, to an undetermined extent, under the economic control of the former. The impossibility of such a solution ought to be clear enough.

On the whole, there seems to be no reason why the indemnity should be mixed up with the question of finding security for the international loans which the victorious countries are in need of. The name of a firm which is admittedly crushed and ruined does not generally add much to the security of a bill; and certainly the prospect of being made

something of a co-partner and co-executor in the German indemnity does not add anything to the attractiveness for outside lenders of loans to the victorious countries.

SECOND MEMORANDUM

I

THE PRESENT SITUATION

My "Memorandum on the World's Monetary Problems" (in this paper referred to as "the first Memorandum"), which was published by the League of Nations for the International Financial Conference held at Brussels in 1920, was completed in June of the same year, and consequently refers to monetary conditions in the earlier part of 1920. Since that time, much has occurred which makes further observations on the subject necessary. New experience has been accumulated, furnishing material by which the earlier analysis can be tested; and in some important respects conditions have altered so essentially that a new situation has to be taken into account in drawing general conclusions, and particularly in framing practical recommendations.

In the beginning of 1920 inflation was still going on in most countries; the general level of wholesale prices reached its maximum for England, France and the United States in the spring months, for Sweden in the summer, for Norway and Denmark only towards the end of the year. It was natural,

under such circumstances, that a discussion of the monetary situation should concentrate on the process of inflation, the evils accompanying this process and the measures required to stop it. The aspect of the problem has now been radically changed. During the year May, 1920, to May, 1921, a fall of prices has taken place, perhaps more violent than any other in the economic history of the world. This fall is still going on, and, although it seems to have been retarded during the last few months, the definite end of the movement is not yet in sight.

The downward movement of prices has not, as is sometimes assumed, been merely a spontaneous result of forces beyond our control. It is essentially the result of a policy deliberately framed with a view to bringing down prices and giving a higher value to the monetary unit. This policy of *deflation* has its root in the popular idea that pre-war price-levels are still to be regarded as "normal," and that stable economic conditions can be attained only by bringing prices down to the old levels. In most countries, in spite of the enormous fall of prices that has already taken place, we are still far from this end, and there is consequently plenty of room for a continued policy of deflation on such grounds.

A prolonged fall of prices must necessarily have an extremely disturbing effect on production and trade, and it is this consequence of a policy of deflation which has manifested itself most clearly during the last twelve months.

A year ago, the productive capacity of the world was fairly well occupied, and labour, on the whole, found fairly sufficient employment. In this respect, conditions are now, as everybody knows, very different.

The world's work has been brought to a standstill to a degree that we have never witnessed before, and unemployment has risen to alarming figures, particularly in countries where the policy of deflation has been applied most severely.

It is only natural that our attention should now be directed primarily to the situation created by this development, and that a critical examination of the whole policy of deflation should occupy the foreground in any discussion of the monetary problem at the present time. It is, indeed, of the highest importance that the aims of this policy should be reconsidered, and that the effects of it, as far as they have shown themselves hitherto, should be brought into the clearest light.

The lead in the general movement towards lower price-levels was taken in March, 1920, by Japan, where inflation, as measured by wholesale prices, had reached the figure of 320. In June, this index had already been brought down below 250. In May, a corresponding movement began in the United States, where the price index of the Bureau of Labour then stood at its highest point, 272. A year later, this index had been brought down to 151. The United States have, by this violent reduction of prices, probably brought themselves nearer to the pre-war price-level than any other country. This achievement has undoubtedly been the result of a more deliberate and consistent policy of deflation than has been enforced elsewhere, and therefore the effects of such a policy can best be ascertained by a study of American experience.

These effects have, in the case of the United States, been rather pernicious. The continuous expectation

of a further fall in prices has evidently had a very restricting influence on the buying of the general public, and important branches of production have suffered severely from this sudden collapse of the market. The trades most seriously affected have been those engaged in building and construction, because the prospect of a continued fall of prices naturally makes enterprise particularly dangerous in cases where large amounts of capital have to be sunk in an enterprise which yields only a slow return over a long period of years. The steady reduction of prices has made it impossible, in a great many cases, to pay back money borrowed at a time when prices were higher. Thus, a large amount of what is called "frozen credit" has been created. The liquidity, and even the ultimate solvency, of smaller banks have thereby been impaired to such an extent that severe measures became necessary. Further restrictions of credit have followed, with the result that prices have been forced down still more and fresh amounts of "frozen credit" have been created. The process of deflation has evidently, in this case, led to a vicious circle from which it seems extremely difficult to escape.

The monetary policy of the United States has had an important bearing on the treatment of the corresponding problems in other countries, anxious to keep up their currency at pre-war parity with the dollar, or, at any rate, not to let it suffer a further depreciation in comparison with the dollar.

Such countries have undoubtedly been driven, by the action of the United States, to proceed further on the way of deflation than they would have deemed wise or expedient had they only had to look upon

the matter as an internal monetary problem. The incessant rise in the purchasing power of the dollar has, however, made vain every effort of other countries to keep up their monetary standards in relation to the dollar. This is particularly conspicuous in the case of England. The "Economist" index of wholesale prices (if referred to the mean of 1913 as 100) stood in May, 1920, at 304, whereas the index of the United States, as mentioned above, stood at 272. The serious efforts which England has made since that time to raise the value of the pound sterling have resulted in a fall of the general level of prices to 182 in May, 1921. But, as in the same period the American index had fallen to 151, the relative position of the pound had not been bettered. The quoted figures show that the pound sterling was only 10·6 per cent. behind the dollar in May, 1920, but 17 per cent. in May, 1921.

The results of the deflationist efforts of other countries are similar. Japan, the Scandinavian countries, France, and even, to some degree, Italy, have succeeded in bringing down, during the period May, 1920, to May, 1921, their general level of prices, and thus raising the internal value of their money. But the internal value of the dollar having in the meantime been increased still more, the relative position of the monetary units of these countries in regard to the dollar has in all cases become worse.

The race between all these different countries to increase the purchasing power of their monetary units has made any stabilisation of the relative values of these units, and, therefore, of the exchanges between the countries, impossible. The instability and uncertainty of monetary conditions are, in spite of all

sacrifices which the deflation policy has involved, just as great as they were a year ago. Indeed, the world has now every reason for calling a halt, and asking whether its monetary affairs could not have been managed more wisely if the different countries had come to a mutual understanding to find a rational solution of the problem.

The fall in prices has, of course, not been uniform for all commodities. This could hardly have been expected, even if the whole movement had been provoked exclusively by monetary policy. As it is, other factors have played an important part in the revolution of the whole system of prices which we have witnessed. We need only think of the breakdown of Central and Eastern Europe and the resulting disappearance of a demand which used to have great importance for certain commodities ; or of the sudden and almost complete annihilation of the world's saving capacity, which brought the trades engaged in construction to a standstill, or of the general insecurity and distrust in the future which has necessarily held back the demand for everything not of immediate use. These factors must inevitably have caused great alterations in the usual relations between prices. The attention of the business community, like that of the general public, is naturally attracted towards such price movements, and there has therefore been a disposition to believe that the factors which have been described are the real causes even of the fall in the general level of prices. This is the reason why the rôle of monetary policy has only been recognised so slowly and so reluctantly. In reality, a fall in the general level of prices is always essentially a monetary phenomenon. The great disturbances

alluded to can hardly have caused a reduction in the average level of prices in any country, except in so far as the general feeling of insecurity may have induced people not to exercise their buying capacity and to increase their reserves of money.

Such action, which is in itself of a monetary character, seems indeed to have been taken to a certain extent during the last year. In the preceding period of rising prices the stock of money generally grew in about the same proportion as the price-level rose. The subsequent fall of prices has, however, not been followed by a corresponding reduction of the means of payment. This anomaly, which I think can be observed in almost every country where prices have fallen considerably, cannot well be explained otherwise than as due to a hoarding of money or, say, to an unusual increase in the demand for cash. An investigation into this question which I made for Sweden revealed the interesting fact that bank deposits as well as bank-notes of the higher denomination (1,000 kronor) had been reduced about normally and that bank-notes of the smallest denominations (10 and 5 kronor) had also been reduced, although not so much. But in the notes of medium denominations (100 and 50 kronor) an actual rise had taken place. These observations gave some indication of the reason why the decline in the total volume of the means of payment—which might have been expected to decrease simultaneously with the fall in prices—has been retarded. Certain classes, perhaps mostly labourers and peasants, who do not use cheques for payments, have accumulated notes of middle denominations in the period of abundant income and now keep them as a reserve, whereas the stock

of money actually used for payments has decreased approximately as expected. Whether this result has a more than local bearing can be decided only after similar investigations in other countries.

It should also be observed that the index of wholesale prices, as now constituted, does not represent a true and stable level of prices. In many countries, wholesale prices to-day are to a great extent, so to speak, bankruptcy prices, the quotations being influenced, more or less considerably, by forced sales of stocks. It is commonly known that in a great many cases commodities cannot be produced at a cost which would be covered by the prices of the present demoralised markets. An index number which is an average of such prices is no trustworthy representation of the actual situation in regard to prices. Only when prices have adjusted themselves to one another so as to make prices of products correspond to their cost of production, can we regard the usual index number of wholesale prices as a fairly reliable index of the movements of the general level of prices. This means, in particular, that wages and prices of commodities must be adjusted to one another so that wages truly represent the price which the consumer is willing to pay for the service rendered. It also means that prices of commodities must include that remuneration of capital which is necessary in order to acquire the service of fresh capital. It is well known how very far our present system of prices is from satisfying these conditions.

Accordingly, if the present index numbers of wholesale prices give a somewhat exaggerated idea of the fall in the general level of prices, it is natural enough that the stock of money should not have

been reduced in the same proportion as these figures indicate.

As long as price movements are as irregular as they are at present, and as long as commodity prices, wages and profits have not adjusted themselves to a true economic equilibrium, it must be extremely difficult to find sufficient guidance in any price statistics for a monetary policy aiming at a stabilisation of the purchasing power of the monetary unit. And, indeed, such a stabilisation is never practically possible as long as the whole system of prices is continually disturbed by such violent economic revolutions as are the inevitable consequence of the present unsettled or badly settled political situation. Therefore, a rational treatment of the political problems, in the spirit of mutual co-operation between all nations, must necessarily go hand in hand with the realisation of a well-devised monetary programme. And in this respect, first of all, the whole problem of the German indemnity and the other international war debts has to be settled on realistic and practicable lines and without unreasonable disturbance of the world's trade.

II

THE POLICY OF DEFLATION

Before entering upon a discussion of the course that should be taken in regard to the programme of deflation it is necessary to set out clearly what the process of deflation actually means, and what are its practical effects.

Deflation is, shortly, a process by which the internal value of the monetary unit is increased. This means a deliberate raising of the purchasing power of this unit in regard to commodities and services—*i.e.*, a general and uniform reduction of prices, wages and salaries as measured in terms of the monetary unit. Even this simple observation is important if we are to clear up the current ideas on this question, for deflation has, undoubtedly, gained a part of its popularity from the widespread belief that it meant a reduction of expenses without a corresponding reduction of incomes.

The means of effecting such a rise in the value of the monetary unit is a restriction in the supply of the means of payment and a consequent reduction of the nominal purchasing power of the public. To this end there are two measures at our disposal and, in present circumstances, both must be applied simultaneously. The first and most general is a

restriction of credit, involving a curtailment of the amounts of loans and a more stringent selection between the different demands for loans. But the principal instrument of such a policy is an abnormally high bank rate calculated to raise other rates of interest correspondingly above what the real scarcity of capital would require, and thus to place an effective brake on all forms of demand for credit. By combining such restriction of credit with a high degree of saving, a considerable reduction of the actual purchasing power of the public may be effected. The second measure consists in raising, by taxation, over and above what public expenditure would require, a sum of money to be used for cancellation of a part of the means of payment of the community.

Theoretically, it is no doubt possible to bring down prices by these means as much as need be and to raise the purchasing power of the unit of money almost indefinitely. But, unfortunately, the process is incidentally attended by some rather disagreeable effects. Indeed, we have to take care that we do not get into a position in which we have to admit that though the cure was a success the patient succumbed. The warnings enunciated in the first Memorandum in regard to the dangers of a policy of deflation have shown themselves, during the past year, to be only too well founded. The first and most obvious effect of such a policy is on enterprise and production. Artificially increased difficulties in the way of obtaining necessary credit accommodation, combined with an artificially increased burden of taxation, would in themselves have a dangerously depressing influence on business activity. But the end which is expected to be attained by these means is even more disastrous

in its effects; for the prospect of a long period of falling prices is most likely to kill industrial enterprise and the very spirit of economic progress. The experience which the United States and some European countries have gained in this respect during the last year is indeed so serious, and so valuable for everybody desirous to learn, that we should do well to pay it the very closest attention. This experience should on no account be taken as concerning only a small class of capitalists or business men; it extends more or less to the whole community, involving particularly the threat of ruin to farmers and widespread unemployment to wage-earners.

Hardly less serious are the effects of the policy of deflation on international trade. Not that a high value of its monetary unit would in itself be a drawback to the export trade of a country. The difficulties now experienced by the United States in selling goods to European countries are not due, as seems generally to be assumed, to the higher value given to the dollar by the process of deflation which has been going on in the States. If the exchange value of the dollar, as measured in European currencies, reflected only the higher internal purchasing power of American money the high exchange would clearly be fully compensated by low prices of American commodities and would in no way hamper American exports.

The real disturbance of international trade arises in connection with the *movements* of the internal value of the different monetary standards.

The general uncertainty as to the future of the exchanges, caused by these movements, is most detrimental to all regular business. The alteration of the rates of exchange, which a process of deflation

in one country can bring about in the space of time required for the production in that country of certain commodities for export, may easily amount to such a reduction in the exchange value of the foreign money for which the commodities are sold that the whole transaction becomes a failure from a commercial point of view. True, the money of his own country which the producer receives in exchange has, in the meantime, acquired a correspondingly higher value. But that is generally of no advantage for the producer, who, as a rule, uses this money to pay back debts incurred during the process of production. This analysis shows that the real difficulty is, in principle, the same as the difficulty experienced in production for the home market where deflation, by producing a continuous fall of prices, acts as a great drawback to all forms of production that require more than a very short time.

A sudden fall of prices in the exporting country may also cause a grave economic crisis in the countries which have bought the exported goods at high prices and have delivered them only when the fall in prices has already taken place. Owing partly to such circumstances, American exporters to South American countries have recently seen their orders cancelled and their exported goods accumulated at the ports of entry, whereas, the buying countries experienced severe financial difficulties and the exchange market was brought into complete disorder.

When inflation is going on in some countries simultaneously with deflation in others, it is really not to be wondered at if the result is a general confusion of international exchanges. The prospect of further inflation has, as explained in the first Memorandum,

the effect of depressing the exchange value of the currency concerned to less than its purchasing power parity. Unsettled political conditions may increase the distrust in the future of a currency and aggravate the international undervaluation of it. All these factors have been at work during the past year. In addition, the disturbing effects of the arbitrary regulation of international trade which were set out in the first Memorandum have since that time been demonstrated to superfluity. Short-sighted protectionist measures, particularly in connection with the payment of the German indemnity, have clearly shown themselves to be a most serious factor of irregularity and uncertainty in the whole field of international exchanges.

Finally, we have to take account of the effects of depreciation on public finance. By the enhancement of the value of money which has taken place during the past year, the real burden of public debt has in many countries been increased to a most serious extent; in some cases so much as to make it very questionable whether the country will be able to bear the burden. In consequence, a corresponding aggravation of the burden of taxation will have to be faced whereby enterprise and production will, inevitably, be gravely handicapped during a practically unlimited series of years. The uncertainty whether countries which used to be regarded as first-class debtors will be able in the future to meet their obligations is, of course, a new and a very serious influence, which operates against that restoration of confidence which we so sorely need. If deflation be carried still further in such countries there can be no doubt but that their State finances will break down and public bankruptcy

will have to be declared, or, if this last stage is to be avoided and a veil thrown over the situation, their monetary policy will be again directed on the path of inflation, with the result that a new and probably rather violent fall in the value of the monetary unit will ensue.

Such being the content and the effects of the programme of deflation, we may reasonably ask ourselves for what purposes such a process can be regarded as particularly desirable.

There are several reasons for the general wish to see the monetary standard raised again to something like that its value was before the war. First, of course, the vague popular feeling that a sound economic future depends upon the restoration of pre-war conditions. The present price level is supposed to be abnormal and on this ground a reduction to the pre-war level is demanded. Natural as this view may be, it is fundamentally wrong. No general level of prices, actually ruling in a country with paper money, can be "abnormal." There is, indeed, as explained above, some abnormality in the present situation of prices, viz., that the different prices are not balanced against one another so as to correspond to a stable economic equilibrium. This fault is of a general economic nature, and not monetary. But leaving this point aside and assuming prices to have attained an equilibrium relative to one another, the mere fact that these prices are on an average so much higher than pre-war prices does not stand in the way of the future development of the economic life of the country.

Nor is the high level of internal prices in itself a handicap against the development of the external trade of the country. As soon as exchanges have

adjusted themselves to the purchasing power parity of the money of the country relative to other standards the export and import trades of the country are in their normal state as far as monetary conditions are concerned. Therefore, as a means for securing a revival of external trade, efforts to restore the old parity with other standards are futile, and of course even detrimental because they are the most serious hindrance against the fulfilment of the most fundamental condition of sound international trade—viz., stability of exchanges.

The desire to restore the old rates of exchange is evidently, to a large extent, founded on a feeling that a degradation in the international value of the country's money is somehow a degradation of the country itself. Much might, without doubt, be said in support of this view as long as the deterioration of the monetary standard of the country was going on. But it is a false ambition to try to make good the harm that may have been done in this way by reversing the process, for in monetary matters it is the alteration itself which is most harmful.

A kindred motive for deflation is the desire to keep up the exchange with another country which is raising its monetary standard by a process of deflation. This is a very natural desire, but, having regard to the bad effects of every policy of deflation, the true remedy in such a case lies without doubt in stopping the process of deflation in the other country.

Finally, the desire to restore the old gold standard is a general and very powerful motive for deflation. This desire involves two different aims. First, it is felt that there is no way out of the present paper money muddle than the re-establishment of a gold

standard. Secondly, it is believed, often without much criticism, that this standard must necessarily be the old gold standard. As to the first point, it is possibly true that the desire to revert to gold is so general and so strong that every effort, however well founded theoretically, to build up a sound system of money on scientifically regulated paper standards would prove, for the present at least, to be a failure. But even if this is conceded, it does not by any means follow that the new gold standard must be founded on the same parity with gold as the pre-war standard.

There is one reason, very honourable in itself, for desiring to go back to the old gold standard. Governments and issuing banks have pledged themselves to redeem their notes in gold at a fixed parity; it is looked upon as a breach of faith to declare these notes redeemable in a lower gold standard. The different aspects of the problem of a restoration of the gold standard can only be discussed more fully in connection with a more thorough analysis of the whole gold question. But it may be well to observe here that this way of looking upon the matter is a rather narrow and formal one.

The bearer of a bank-note does not ordinarily ask for gold; he expects to be able to buy commodities for it and usually does so in a very short time. The depreciation of the note during that time has in most cases been negligible and has not caused the bearer any appreciable loss. If the notes were declared to be redeemable in gold according to their present value the present bearers of the notes would in most cases suffer no disadvantage and would perhaps even not notice it.

The redemption of notes in gold has not been pre-

scribed primarily for its own sake, but in order to secure the greatest possible stability for the value of the money of the country. This stability is the principal interest of the public in regard to the money it uses and upon which it bases all its business calculations. Now this stability has already been lost and public faith in the monetary standard has already been disappointed. This is a very bad thing. But it cannot be made good again by any process intended to raise the standard again, in a shorter or longer period, to its earlier value. This would only involve a new period of instability with fresh injury to enterprise and production. These very simple truths would, of course, be generally recognised if people could only become accustomed to look upon the banknote not in the usual formal way, as a mere promise to pay, like all other obligations, but essentially as a representative of the whole monetary system of the country. The primary object of our monetary policy must be to restore soundness and stability to this system, not to fulfil formal requirements of justice which in the overwhelming majority of cases would have no reality behind them.

III

THE GOLD QUESTION

It was pointed out in the first Memorandum that the value of gold had declined very considerably since the beginning of the war. This observation referred to the earlier part of 1920. Since that time, a movement has taken place in the reverse direction, with the result that gold has now regained perhaps the greater part of the loss in value which it previously suffered. This, of course, alters very considerably the practical aspect of the gold problem inasmuch as the restoration of the old gold standard has been made even more difficult for countries with a depreciated paper standard than it was a year ago. But the analysis of the gold problem given in the first Memorandum is still valid. It is therefore only necessary here to add some few observations with special reference to the present situation.

The position which gold held before the war as a monetary standard depended on the general assumption that the value of gold is something fixed to which all other values can safely be related. True, the economists knew that considerable variations occur in the value of gold as measured in terms of the commodities which gold can buy. But as these variations used to be spread over long periods, extending perhaps

over the lifetime of a generation, the average business man was not concerned with them in his daily transactions and therefore usually paid no attention to them.

Now, gold having lost in some few years perhaps more than 60 per cent. of its pre-war value and then in one single year recovered something like half of this loss, it is plain to everybody that gold no longer possesses that stability of value which is the very foundation of its position as a monetary standard for the whole world. This radical alteration has been brought about by the almost complete destruction of the old gold market with its delicate machinery and by the fact that the international payments which this machinery is called upon to serve have grown to such fantastic figures that no machinery which the world ever possessed could cope with them. Prior to the war, there was a fairly free international movement of gold, permitting the metal to flow from one part of the world to another at a difference in price which would now be looked upon as absolutely insignificant. Some countries accumulated big gold funds, but they did it slowly and without appreciable disturbance of the market. And the countries which, as great creditors, might have drawn gold from the rest of the world in any amount did not do so, but used their income from investments abroad to pay for surplus imports of goods or to make new investments in foreign countries. In the case of Great Britain, the actual holding of gold was particularly small in relation to the position of that country in the world's finance and trade. Still, the fact that the country was a creditor country and that the rest of the world owed it such huge amounts of money on call enabled London to keep up a free gold market from which

all demands for gold were normally satisfied without difficulty.

It is this machinery which has been destroyed, all the essential conditions for its working having ceased to exist. The European countries have locked up their gold funds and prohibit, more or less stringently, all export of gold. Even when they are unable to meet their foreign obligations countries refuse to part with their gold; and, curiously enough, the claimants do not insist upon having it, for any considerable reduction of these gold-holdings is believed to be impossible without causing a serious economic crisis in the debtor country, and so, of course, impairing its ultimate capacity to pay. In these circumstances, European gold funds are, for all practical purposes, locked away from the world's markets.

The war, which turned so many creditor countries into great debtors, has created one new big creditor country, the United States. The resulting situation is quite abnormal, in comparison with the conditions to which the world had got accustomed before the war. We now have a big creditor country which has, at the same time, a huge surplus of exports, and whose population has not yet acquired the habit of investing continuously, and on a large scale, in foreign securities; this situation is untenable. It has somehow to be modified so as to open out the possibility of a normal settlement of payments due to America. As it is, an inconveniently large proportion of the debts due to America are simply left unpaid, and the volume of floating credits is thereby increased in a very unsound manner. Actual gold shipments are, to a considerable extent, the only way left open for making payments; and, in fact, America has received a huge

sum of gold from the outside world during the past year.

Of course, a certain scarcity of gold must have been created by this enormous demand for gold for America. Most countries having locked up their gold funds, as stated above, the only regular supply left to the world's market was the current production. It is difficult to see what the result would have been if an extraordinary source of supply had not been provided by the huge exports of gold from Russia which took place particularly during the first half-year of 1921.

The demand for gold for American account has, in these circumstances, undoubtedly been a factor of importance in the sharp upward movement of the value of gold, which is the most prominent feature of the monetary history of the past year. Still, we should have no sufficient explanation of this movement if we were satisfied with a reference to the abnormally great American demand for gold. The question arises: What is the cause of this demand, and how far is it a result of deliberate monetary policy?

It is generally admitted that the United States have caused great inconvenience to themselves, as well as to the rest of the world, by taking so much gold. But, it is said, they could not help doing so. They had simply to receive all gold which the rest of the world cared to send them. The formal truth of this answer cannot be disputed. But it throws no light on the essential question which, for practical purposes, is all important. Was it really necessary that so much gold should flow into the United States? The principal reason why the gold went there is, of course, that gold could buy more commodities there than in other parts of the world. And this higher

purchasing power depended undoubtedly on the American monetary policy. By a deliberate process of deflation the general level of prices, as expressed in gold-dollars, was depressed in the most violent manner, *i.e.*, the value of gold in terms of commodities was proportionally raised. The result was that gold could buy in America a steadily increasing quantity of commodities, and, at all times, a greater quantity of commodities than in other countries; so the gold went to America. Of course, the value of such gold as could be exported to America immediately rose in other countries. The peculiar situation of the market had this effect, that the value of gold was practically determined by the value of the dollar. This value was steadily increased, but it was always possible to buy the dollar with an unaltered quantity of gold. Dollars could, *e.g.*, always be procured by producing gold in South Africa and sending it to New York. And the most advantageous use of this gold was to let it go to America. Had no deflation taken place in the United States, *i.e.*, had the internal value of the dollar been left at the level where it stood a year ago, the steady improvement of the pound sterling and of some other currencies would soon have brought the internal value of each of those currencies to its old parity with the dollar, and therefore with gold; and the condition of the exchanges would then, at any rate, no longer have acted as an additional stimulus to the influx of gold into the United States, which their suddenly won position as a creditor country perhaps, to a certain extent, made unavoidable.

The amount of gold which the United States have taken during the last year is not in itself so important that it would have caused, under normal conditions,

a very considerable rise in the value of gold. This is easy to see if we remember that in pre-war times the loss of a whole year's production of gold would not have raised the value of gold, normally, by more than 3 per cent. The rise in the value of gold is, essentially, a result of the peculiar situation which has bound up the value of gold with that of the dollar and of the deflationist policy of the United States which has steadily raised the internal value of the dollar.

Under ordinary circumstances, the endeavour of a country with a gold standard to bring down prices and thus to raise the internal value of its money would, according to classical doctrine, have caused an influx of gold into that country with a consequent increase in the total volume of the monetary purchasing power within the country. Thus, the depression of prices would have been counteracted and the internal value of the money of the country would have been brought down to that of gold. In the present case, this automatically regulating machinery has not had sufficient opportunity to work effectively. First, the natural influx of gold into the United States has been held back by the prohibitions against gold exports now prevailing in other countries, and the increase in the gold holdings of the States, great as it has been absolutely, has undoubtedly been made smaller than it would have been if the movements of gold had been quite free. Secondly, the gold which has gone to the States has not increased the circulation, or, more generally, the sum total of the monetary purchasing power within the country. On the contrary, this sum has been diminished. The deliberate deflation policy of the Federal Reserve Banks, has, by its severe restriction of credits, resulted in a greater monetary

stock of gold now serving as foundation for a smaller volume of means of payment. Thus the depression of prices has continued and the internal value of the dollar has risen with the result that, instead of the dollar being levelled down to the value of gold, gold has been raised to the value of the dollar. Of course, such a result would only have been possible in the case of a great country like the United States to which the rest of the world incessantly has to pay huge sums for old debts and for fresh export surpluses.

This analysis makes it clear that sound conditions in the world's gold market will never be attained as long as no satisfactory means is found of settling the huge balance of payments due to the United States. The side of this question which concerns the debt of the Allied Powers to the Government of the United States will be discussed more fully below. As to the commercial side of the question, no more need here be said than that a policy by which the tariff walls of the United States are raised to almost prohibition limits must aggravate, to a serious degree, the solution of a problem which is in itself already difficult enough. If the United States wish to get paid, they must take commodities in payment. Indeed their newly-won position as a creditor country, claiming huge amounts of interest and profit on foreign investments, seems to involve the necessity of a radical change in their balance of trade, turning the traditional export surplus into an import surplus. This necessity can hardly be avoided, but might, to some extent, be mitigated if the American people could get accustomed to buying foreign securities and to investing capital abroad, both regularly and on a large scale. But the development of such habits

will necessarily be a slow process and have a comparatively narrow scope as long as the rich natural resources of the States give abundant opportunities for a more profitable use of capital at home. Therefore, the problem of the payments to America will, even with the wisest commercial policy, present great difficulties.

A situation which makes the world's gold market dependent, to an extreme degree, upon one single country with an unsettled balance of payment must inevitably involve great insecurity in respect to the future value of gold. It is quite conceivable that the monetary policy of the United States may take a new course and that the period of deflation which has been discussed here may be followed by a new period of inflation reducing the internal value of the dollar and, therefore, of gold, perhaps very considerably. This would, of course, for the moment make resumption of gold payments for some European countries comparatively easy. But there would be no security in a gold standard established in such a manner. As long as the very foundation of the gold market is insufficient to give it the necessary stability there is always the risk that fresh violent alterations in the value of gold may make it impossible, or at least inadvisable, for most countries to keep up their gold standard. Our present experiences will, by and by, teach us that the use of gold as a common standard for all countries, to which we were accustomed before the war, necessarily depends on two conditions—viz., first, that we have a world-wide gold market with fairly free movements of gold, and secondly, that the world's balances of payment are normally settled, without much recourse to this gold market.

Turning now to European conditions, it is plain

enough that the German indemnity and the Inter-Allied war debts constitute factors of uncertainty of such importance that it is vain to expect any stability in the system of international payments as long as no satisfactory settlement of these debts has been arrived at. The disturbing effects on the machinery of the exchanges, which any attempt at an actual payment of these debts would have, has been sufficiently demonstrated by the relatively small indemnity payments already made. It is hardly conceivable that even the best established system of gold standards could stand the strain of the payments which an actual liquidation of these debts would require. It is easy enough to stipulate that such-and-such sums shall be paid in gold. But it is much more difficult to foresee what effect such stipulations, if actually enforced, will have on the gold market and on the value of gold. The mere existence of huge debts for which no regular machinery of payment has been provided makes the future of the value of gold extremely uncertain.

In late years, the Eastern demand for gold has also proved to be a considerable factor of insecurity in the gold market. The amounts of gold taken by India and China have shown extraordinary variations; they have varied from less than nothing in 1918 to a maximum in 1919 of more than half the world's total production for that year. These variations have, of course, seriously affected the balance of fresh gold available as money for the Western world, and have thereby contributed to the instability of the gold market.

International economic relations and the actual situation of the gold market being such as here out-

lined, it seems to be almost a practical impossibility for any European country, acting alone, to restore a gold standard, even at a reduced parity. This is clear enough so far as the smaller countries are concerned. Theoretically, any country which has attained an equilibrium in its State finance might choose a gold parity corresponding to the present value of its money, and henceforth regulate this money so as to secure its convertibility in gold at the fixed parity. To meet the demand for gold which would arise from occasional fluctuations in the exchanges, the country would need a gold fund of a certain size. But a small country which accumulated a gold fund sufficient for occasional demands from its own internal market would find this fund quite insufficient for satisfying similar demands from abroad. If the country had been alone among European countries to restore the gold standard, it might quite easily see its whole gold fund suddenly exported to satisfy foreign demands for gold. For this reason, no small country can take the lead in the restoration of the gold standard in Europe.

The only European country which can conceivably become strong enough to resume gold payments independently of the others is Great Britain. But the maintenance of a gold standard and a free gold market would meet with great difficulties so long as the old position of London as the world's creditor for short-term loans had not been restored. A serious obstacle to the restoration of a British gold standard seems to lie in the British war-debt to the United States Government. Until an agreement has been arrived at which removes the threatening influence of this debt upon the equilibrium of international payments

a re-establishment of a free gold market in England can hardly be expected.

On the other hand, it must not be forgotten that, if all European countries which are now locking up their gold funds decided to let gold out freely, the United States would soon get so much gold that it is difficult to see how they could prevent a violent fall in the value of gold. It would hardly be possible to increase the percentage of gold reserves to liabilities indefinitely, and the banks would therefore be forced to extend their credits and thus to increase the volume of the means of payment. Then the general level of prices would rise—*i.e.*, the purchasing power of the dollar would fall, perhaps so much as to bring down the international value of the dollar to the old parity with the pound sterling. In this way, English money might, as pointed out in the first Memorandum, regain its old gold parity. The same would then probably be the case with the Swedish, Dutch and Swiss currencies. But whether any real stability in international monetary relations were thereby reached, would still depend on the fa-rsightedness and stability of American monetary policy and on the other conditions described above.

A real stability of the gold market can, in fact, never be obtained until the gold standard has been restored in several countries and actual gold payments have been resumed in a considerable part of the world. The true basis of a trustworthy gold market can only be a world-wide international trade, carried on on a gold basis. On the other hand, such a restoration of the gold standard is only possible on the condition that the gold market has already acquired some stability. The only way to a solution of a problem

which presents such complications seems to lie in a mutual co-operation of the nations with a view of securing that agreement in policy and that unity of effort which alone promise success where isolated action would necessarily fail. A rational settlement of the question of war debts and their payment is, of course, a *sine qua non* if any effort to restore stability and reliability to the world's monetary machinery is to be successful. But the co-operation here suggested would be specifically directed at an arrangement with regard to the way in which this machinery should be connected with gold.

Let us now suppose, in order to get a complete view of the subject before us, that the particularly disturbing factors now discussed have been removed, and that more normal conditions have thus been restored to the gold market. The resumption of gold payments would then be within the practical reach of all countries which had obtained sufficient control over their own monetary policy to enable them to secure a fair degree of stability for the value of their money in terms of commodities. The parity with gold which such a country could obtain for its monetary standard would be determined by the relations between the value of its money and the value of gold, both values being expressed in commodities. The higher the value of gold at such time, the more impossible it would be to restore the old gold parity and the lower the new parity that would have to be chosen. It is therefore a common interest of all countries desiring to restore a gold standard, that the value of gold should be kept as low as possible, or at any rate, should not be raised unnecessarily.

Now, a keen competition for gold will clearly

tend to raise this value considerably. A general restoration of the gold standard cannot, therefore, be furthered by the usual popular device according to which every country should try to accumulate the largest possible gold fund. Such a policy can only have the effect of forcing a more general devaluation of monetary standards in comparison with gold and of making in each particular case such devaluation go much further than if a more reasonable attitude towards the problem had been adopted. If the world really wishes to see gold restored again as a common standard of value, the different countries must come to some understanding tending towards a general restriction of their monetary demand for gold.

The gold problem has one other aspect which requires some attention. Even if we could assume all the peculiar difficulties of the present situation removed, the question would still remain whether, for the future, we can reckon upon a sufficient supply of gold to give the metal a stable value.

As to the future of the world's gold market, it was observed in the first Memorandum that stability in the value of gold (assuming the relative demand for the metal to be constant) will require a yearly production of gold amounting to 3 per cent. of the total mass of gold at any time. This production would cover the need for fresh gold created by general economic progress and by the absolute loss of gold annually. At present, stability in the value of gold would require, on these grounds, an annual production of slightly over 100 million pounds, and this production would have to increase annually by about 2·8 per cent. The world's total production of gold amounted, however, in 1920 to only about 70 million pounds. After

having reached a maximum of 96·4 million pounds in 1915, the production has steadily decreased. The actual figures are in millions sterling :—

1915 . .	96·4	1918 . .	79·0
1916 . .	93·5	1919 . .	75·2
1917 . .	86·3	1920 . .	70·0

Expert opinion regards it as probable that a rise in production will take place up to something like 75 millions, perhaps 80 millions, but hardly more. We have therefore to reckon with the fact that the world's production of gold has become, definitely, insufficient for the rate of economic progress which we used to regard as normal before the war. Assuming that the world is not going to give up this rate of progress, a general restoration of the gold standard with the consequent progressive development of the monetary demand for gold would inevitably result in an increasing scarcity of gold and a continuous rise in its value. This would mean that the world condemned itself, for an unlimited future, to a slow but progressive process of deflation with all its evil effects on enterprise and production as well as on public finance. The programme suggested in the first Memorandum of a progressive reduction in the monetary demand for gold is, under such circumstances, of very practical importance. In fact, the only reasonable alternative to such a programme is the immediate and definite abandonment of the use of gold as a monetary standard.

IV

PRACTICAL MEASURES FOR STABILISATION

Restoring of the gold standard being such an extremely complicated problem, the definite solution of which is certainly not to be expected in the immediate future, the first practical aim for the monetary policy of every country must be to give a stable internal value to its own monetary standard. This is all the more obvious because such a stabilisation is, in any event, a necessary pre-requisite for the restoration of a stable gold standard.

The question then arises what means we have at our disposal for carrying through, in actual practice, such a policy of stabilisation. On one point we must first be clear: even the best monetary policy will not be able absolutely to prevent fluctuations in the general level of prices. Least of all would this be possible when the up and down movements of the price level are so violent as they are at present. What we may aim at is to counteract these movements and thus to keep them within the narrowest possible limits. It follows that we have to apply quite opposite means in the different phases of price fluctuation. In a period of rising prices and of an increasing volume of credits and of means of payment we have to direct all our efforts towards restriction. A high rate of

interest and a severe cutting down of the demands for credit are then the right means. Again, in a period of falling prices, general lack of confidence and reduced demands for credit we have to use the opposite means. In other words, at the top, or rather already while we are approaching the top, deflation is the right thing to be recommended. In the contrary case a certain inflation is called for.

This may seem a dangerous doctrine, when so much energy still has to be bestowed on combating the tendencies to continued inflation which, indeed, cannot yet be regarded as dead; and certainly, it *is* dangerous. If, nevertheless, such a programme must be drawn up, it is of paramount importance that it be made clear that the ultimate aim of monetary policy is stabilisation. If the authorities wish to command the confidence of the public they must bind themselves in the most solemn manner to such an aim. But this involves their having decided for themselves what value they wish to give to the money of the country; that is to say, what is the general level at which they will attempt to stabilise prices. And such a decision must be made public. Indeed, the co-operation of the whole nation is necessary for attaining the end, and, therefore, the nation must know that there is a definite aim and a unity of purpose in the changing phases of action and in the seemingly opposite measures applied.

The principal practical difficulty in carrying out such a policy of stabilisation is the irregularity in the movements of prices. Different categories of prices move differently. Generally, wholesale prices lead the way, retail prices and wages lagging behind; and this is true in the downward as well as in the

upward movement. It is then not quite easy to say, at any particular moment, in which phase the whole development stands; the more so as even prices of the same category often show very divergent movements. We may find some guidance in the following rule: when wholesale prices are considerably above cost of production (including normal profits), this is a sign of inflation, and a policy of deflation should be applied; again, when wholesale prices are generally insufficient to cover the cost of production we may take this as a proof that the process of deflation has gone too far, and that more normal relations have to be restored by an extension of credit and an increase in the monetary purchasing power of the community.

The level at which we wish to stabilise wholesale prices should be chosen so that the necessary equilibrium between the price of products and the cost of their production is established with the least disturbance to wages and other prices entering into the cost of production. But as different classes of wages have, generally, moved very differently, and as their relative position is not now compatible with a true economic equilibrium, a readjustment of wages will in most cases be necessary. This readjustment will inevitably involve some curtailment of real wages for certain classes of labourers, and is therefore likely to cause some unrest and some difficulties. In order to avoid any unnecessary aggravation of these difficulties, it is probably wise to abstain from every attempt to press down the general level of monetary wages. If this has already been done to some extent, there is all the more reason for not insisting upon a further reduction. The general level at which nominal wages should be stabilised having been agreed upon in this

manner, the stable level of wholesale prices is the level at which cost of production is covered.

Even with these general rules we shall certainly, in practical life, have to face situations where it is extremely difficult to find reliable guidance for the rational treatment of the problem of stabilisation. We can therefore only hope to realise our aim gradually and in a relative manner. But it is already a very important step forward if we can considerably reduce the present abnormally wide fluctuations in the price-level.

Every policy of stabilisation will, as already explained, necessarily involve the direction of monetary policy in periods of depression, towards a rise in prices. It is then interesting to analyse the effects of such a policy of inflation as distinguished from the continuance of inflation at a time when inflation has already brought prices to an abnormal height. The difference in effect is indeed very considerable.

When production has already been artificially stimulated by inflation, every further extension of credit and creation of money means a net increase in the nominal purchasing power of the community without any corresponding increase of the mass of commodities to be sold. The productive capacity of the community being already fully employed there is no possibility for an extension of production. The fresh purchasing power created can therefore only find something to buy by causing a general rise of prices. Thus prices, as explained in the first Memorandum, must rise.

In a period of severe depression brought about by a process of deflation, a return to more liberal credit policy will set production going where it has

come to a standstill, and procure employment for labour, machinery and other instruments of production which have before been idle. The mass of commodities to be bought will therefore very soon be increased, and thus there will be something to set up against the additional purchasing power which may have been created. The rise of prices caused by the extension of credit must, consequently, in this case be smaller than in the case of continued inflation. The policy now discussed will have a decidedly beneficial effect on the economy of the community, increasing its real income and mitigating the social troubles connected with prolonged and widespread unemployment. These advantages will go far to balance the evils unavoidably caused to certain classes by every reduction in the value of the monetary unit. And if the policy of stopping deflation and reverting to a higher normal level of prices is managed well, it is quite possible that the balance for the community as a whole may show a very considerable net advantage.

The condition is, of course, that the new credit created is used exclusively for productive purposes, and not only that, but for such investments which are likely to call forth, in the most immediate future, an important increase of production. There are always, under the circumstances assumed, ample opportunities for investments of this kind. For such productive concerns as have been going and are fully equipped, but have been brought to a standstill by the economic depression caused by deflation, generally need little fresh capital to set them going again. The confident belief that prices have ceased to fall, and are even likely to rise moderately, is in itself a very

potent factor in setting the wheels of industry turning round. Further, there are, particularly in the present state of things, several points in the productive organisation of the community where something, perhaps very little, is lacking which would give to the whole machinery its full efficiency. If at such points the needed equipment is provided, the addition to the total output may prove out of all proportion greater than the expenses involved. If, *e.g.*, some bridges of a great railway system have been destroyed, or if there is a lack of locomotives, an investment of capital for making good such deficiencies will soon be productive of increased efficiency, not only in the whole railway system, but in the productive machinery of the country at large. If, at the lowest stage of depression caused by a continued process of deflation, fresh credit is created for these and similar purposes, the community may very soon see its real income, *e.g.*, in the shape of home and colonial supplies of food and raw materials, increased so much as to justify the increase in the sum of nominal means of payment.

The public will probably be inclined to believe that such credits may just as well be used for any other purpose, and particularly there is always the risk that such an opening will be exploited for an increase of public expenditure. Therefore, when recommending, under the circumstances here assumed, a more liberal credit policy, one feels obliged to underline very strongly the warning against any abuse of such policy.

A return to a more liberal credit policy during the deepest depression is not likely to cause a fresh wave of over-speculation or to be a temptation for investors to spend further capital on industrial equipment which is already more than sufficient. The psychological

conditions are very different from those prevailing in a period of continued inflation, and the effects of a more plentiful supply of means of payment will therefore be different even in this respect. A low rate of interest may certainly call forth considerable issues of new securities on the stock exchange. But, in reality, such a result will mainly represent the transformation of old floating engagements to more durable investments, and ought therefore to be greeted with satisfaction as a sign of a wholesome consolidation.

Still, the directions which investments take and the purposes for which fresh capital is required should be carefully watched. A certain selection will be necessary and for this purpose the co-operation of the whole business community, and particularly of the banks, is required.

V

DISTURBING EFFECTS OF INTERNATIONAL WAR DEBTS

It is generally recognised that the existence of the huge international debts which the war has left behind it has a disturbing influence on exchanges, and adversely affects the restoration of a gold standard. But the real gravity of this influence is not always perceived, nor is the true character of the difficulties created by these debts sufficiently clear to the public mind. Certain aspects of the problem of post-war international indebtedness having been brought into fuller light by the experience and the discussions of the last twelve months, it is necessary, even within the limited scope of this paper, to give some attention to this problem.

Foremost in practical importance among the international war debts stands the German indemnity, not merely on account of its magnitude, but still more because payments have actually begun to be exacted, and will continue to be exacted in the near future, under the threat of heavy and far-reaching penalties, whereas in the case of other war debts payment is still looked upon as a problem of to-morrow. The difficulties involved in the actual payment of the debts and the disturbing effects of an attempt to enforce such payment are, however, in both cases of the same nature; and an analysis of the case of the German

indemnity has, accordingly, a bearing beyond the limits of the particular case, which it would be well to have in mind in every discussion of this controversial subject.

The adverse influence of the indemnity on the world's recovery in general, as well as on efforts to restore sound monetary conditions, is due in the first instance to the fact that it is considered extremely dubious whether Germany will really be able to fulfil the payments fixed in the London Agreement. It is indeed feared among those best acquainted with the details of the matter that the payments of the present year will more or less exhaust Germany's available supplies of foreign exchange; and that, therefore, the whole scheme for the payment of the indemnity will break down in 1922. What then will happen is the very troublesome question which more than anything else prevents the establishment of equilibrium in the world and which at the same time is one of the foremost causes of the general distrust of the stability of any system of money or international exchanges.

The relatively small indemnity payments hitherto required according to the London scheme seem to have been made possible only by aid of extraordinary measures, and particularly by a further resort to the practice of selling German marks abroad. This practice must, as explained in the first Memorandum, depress the international value of the currency concerned beneath its internal value, and the depth of the depression must increase with the extension of the sales. In the case of the German mark the undervaluation has gone so far that, whereas the internal value of the currency may perhaps roughly be estimated at about twopence, the value in exchange is

less than one penny. Buyers of German marks speculate on a rise of the exchange value to something approaching the internal value; but evil experience has taught them that this is a rather dangerous speculation, and, therefore, a wide margin of possible profit, at present more than 100 per cent., is required to call forth fresh buyers. Of course, there is a limit for such sales beyond which no margin is able to call forth an appreciable demand, and every considerable extension of the sales naturally strengthens the fear of an approaching collapse of the market.

The danger of Germany's being unable in a near future to fulfil her obligations, and of the political consequences which this failure would involve, is another important element in the growing distrust felt towards the German currency; and with a complete lack of stability in this part of the world's monetary system, there is little hope of any real stability being restored to the system as a whole.

Assuming an arrangement to have been made which removed the difficulties as to the German payments for the immediate future, the question will arise whether Germany will be able in the long run to fulfil the obligations laid upon her by the London scheme. In this connection it should be recognised that calculations of Germany's capacity to pay based on the estimated pre-war saving capacity of the country are entirely unsound. In the first place, the savings of the community are not, as is so often preached and believed in internal politics, a sum of money which may be used for any purpose which may be thought desirable. On the contrary, such savings are a necessary condition of economic progress, and they immediately take the form of the real capital

(houses, machinery, etc.) required for this progress. Of course it may be said that a country must sacrifice progress in order to pay its debts. But progress cannot well be stopped altogether without injury to the producing capacity of the country. The constant improvement of technical methods makes it necessary that the whole industrial equipment of the country should be continually renewed, and this is practically impossible without a constant supply of fresh capital, *i.e.*, of savings. A growth of population clearly creates an equally imperative need for capital.

Secondly, the savings of a country of the West European type normally amounted before the war to something about one-fifth of the current income of the country, and this rate of saving sufficed to secure the normal rate of progress. The savings of Germany were approximately on that scale. It seems a very moderate estimate to say that five years of the most terrific warfare, ultimate defeat and subsequent heavy penalties, must have reduced the earning capacity of the country by 20 per cent. The present income of Germany would then only correspond to that part of her pre-war income which was consumed, and any indemnity would have to be paid out of this income. Undoubtedly the main source of the indemnity must be a reduction of the pre-war standard of life of the German people. Such a reduction, however, is not practically possible without injuriously affecting the standard of life of the mass of labourers, and involves an imminent danger that the efficiency of labour also will be reduced. But with a diminished efficiency of labour and a curtailment of the supply of fresh capital, the producing capacity of the whole

country must decrease. Once this effect has been produced by too heavy claims for payment of the indemnity, further exaction of such claims will be economically impossible, and no "sanctions" will be able to alter this fact.

On this ground it seems natural enough that there should steadily become more general and more profound the fear that the whole plan of indemnity payments, as now contemplated, will ultimately break down and the world be plunged again into political and economic chaos. In such a state of things it is obviously somewhat difficult to lay the foundation of the monetary system of the future, or, indeed, to do anything for the stabilisation of currencies and exchanges. As a matter of fact, practical business men in leading positions are now more and more often found to doubt the usefulness, in present circumstances, of any efforts in this direction. Still, if we are true to ourselves, we must feel that no one can really take the responsibility of abandoning all such efforts and acquiescing in the present monetary confusion.

A disturbing element of a more technical nature, but of an immense practical importance, is the stipulation according to which the indemnity has to be paid in gold. The future value of gold is, as explained above, extremely uncertain, even the main factors determining it being beyond our control so long as no agreement has been reached between the leading countries with regard to their monetary demand for gold. The probabilities point, as we have seen, to an increasing scarcity of gold, with a consequent rise in the value of the metal. The stipulation of such huge payments in gold as the German indemnity

represents cannot but materially affect the market, and will probably tend to strengthen still more the demand for gold in a world already insufficiently supplied. Thus it might easily happen that the enhanced value of gold made the burden of the indemnity much heavier than was originally contemplated, and in the end rendered it impossible to bear. At the same time, such a rise of the value of gold would make all other debts contracted in gold much heavier, and in many cases would completely undermine the solvency of debtors, public as well as private. In addition, all efforts and sacrifices for the restoration of a gold standard would probably prove futile, and the countries which had made such attempts would find themselves thrown back again on a paper basis. Even if a country succeeded in keeping up the gold standard the confusion would hardly be diminished, for it would have to face a heavy fall in prices, and probably, as a result thereof, a serious depression in trade and production.

It may be taken as certain that these grave consequences of the fixing of the indemnity in gold have not been taken sufficiently into consideration. There is, however, clearly no hope of a restoration of stability in the world's monetary system until some means has been found of removing this particularly disturbing factor.

Another side of the question before us is the problem of what has been called "the mobilisation of the indemnity." The idea that the indemnity, or a part of it, could be discounted and thus turned into immediately available money has certainly not yet been definitely abandoned. It was said in the first Memorandum that the prospects of a great lending country

—the United States—offering an international loan on the security of the indemnity were practically nil. This view has since been confirmed. American bankers are not even willing to have the Reparation Bonds introduced into the American market. The declaration given in this matter on behalf of the American delegation at the meeting of the International Chamber of Commerce in London this summer was very clear. It was feared that any attempt to sell Reparation Bonds in America would depress prices and "spoil the market, not only for these bonds, but for foreign offerings generally, and thus seriously interfere with all efforts to aid the European situation." That the sale of the bonds in any other country is still more impossible is plain enough. As long, however, as the owners of the bonds are in urgent need of money, it must always be feared that attempts will be made to put huge amounts of the bonds on the market. This danger will be a constant element of insecurity in transactions in international exchange and will make the much-desired stabilisation of rates still more difficult.

Finally, we have to consider the indemnity question from the aspect which has so prominently engaged international discussion on the subject during recent months, *viz.*, the unwillingness of the claimants to receive the indemnity which they claim. This absurd situation, as it might be thought, is a result of the widespread influence which protectionist ideas have acquired since the war, principally by the exploitation of war-antagonism. The countries which are entitled to participate in the indemnity are not willing to receive German products; nor do they wish, in cases where actual reparation is required, to open their

doors for German labour or German enterprise which would share the employment and profits offered by reparation work.

Sometimes the ultimate consequences of this standpoint are recognised and it is declared that the indemnity must do more harm than good to the country receiving it and that it is better to abandon the whole indemnity. This is, of course, wrong. No economist, reasoning on purely economic grounds, could endorse such a view. To receive an indemnity is undoubtedly an economic advantage. But it is not an unmixed advantage. The indemnity must somehow be paid in commodities and services; these commodities and services must compete with commodities and services supplied by the receiving country itself, and the competition must be so far successful as to allow the indemnity to be paid. In some branches of industry such competition is bound to have very disagreeable effects. The full real advantage can only be drawn from the indemnity payments when the economic life of the country has been adjusted to the new conditions. During the first period of adjustment the disadvantages will probably even preponderate. When the indemnity has ultimately been paid, a new adjustment will be necessary and will cause disturbances which, though probably not so serious as those of the first adjustment, will be disagreeable enough.

At present, the primary problem for the countries which claim the indemnity would appear to be that of avoiding the initial disturbances, or at any rate mitigating them as much as possible. The usual plan is to throw these disturbances on to other countries, close the frontiers against German compe-

tition and let the flood of German goods go elsewhere. This course does not seem entirely just to other countries which have nothing to do with the indemnity, and these countries can hardly be expected to give their support to such a policy of economic devastation. The consequence has been a general growth of protectionism and, notwithstanding all that was said at the International Financial Conference at Brussels in favour of free trade and free intercourse between nations, the world is unmistakably moving in the opposite direction. This result of the indemnity is most unfortunate and injurious and is perhaps the most important hindrance to the economic recovery of the world which, even for the Allied countries, is of much greater interest than any indemnity. What makes the protectionism of to-day so especially pernicious is that it leaves everything in a state of uncertainty. The world's trade can adapt itself to adverse conditions, but in the present state of affairs no one knows to what conditions trade should be adapted.

As long as the general situation of production and trade remains so abnormal and so uncertain it is, of course, vain to hope for the restoration of any stability to the international exchanges. In this connection the intimate connection between the present monetary problem and the problem of the indemnity shows itself with singular clearness, and it becomes plain how indispensable a complete settlement of the whole question of the indemnity, and of the means by which it is to be paid, is as a condition for the success of any positive work on the reorganisation of the world's monetary system.

What has been said here about the German indem-

nity applies also to the other international debts which the war has left behind it. There is great uncertainty with regard to at least the greater part of these debts, as to whether the debtor countries will ever be able to pay the debts. There is also the fear that attempts may be made to bring these debts on the market, and to enforce payments for interest and sinking fund. This general uncertainty with regard to the future of the international war debts causes a corresponding amount of insecurity in the international exchange market. The effects on the value of gold of an attempt to enforce the payment of these debts in gold can hardly be ascertained. Further, so soon as payment of these debts is seriously considered, the world will realise the immense difficulties of such a reorganisation of the world's trade as must be required for effecting the payment. It will then perhaps also be recognised more generally how unfair it is that a creditor country should be free to aggravate the real burden of the debts for the debtor country by not allowing payment in what it can deliver, or by raising high tariff walls against the commodities by means of which it is most convenient for the payment to be made. These considerations will, we may hope, lead to the recognition of a new rule of international justice creating more equality of rights between creditor and debtor nations.

Such are the almost unsurmountable difficulties of the problem of the international indebtedness created by the war. The more attention one gives to this problem, the more unavoidably one is driven to the conviction that some reduction of this debt must take place. This reduction would necessarily mean a sacrifice for the principal creditor countries,

Great Britain and the United States. But as these countries are, at the same time, the greatest participants in the world's trade, they would also have the foremost interest in the compensation which would accrue from a revival of the world's trade and a facilitation of the restoration of stability to the different monetary standards and the international exchanges. Great Britain could exchange claims on her Allies for certain amounts of indemnity bonds and cancel them. The United States could do the same on a still greater scale. They would thereby avoid all the disagreeableness and the real inconvenience of becoming Germany's creditors. Such a policy would, I do not hesitate to say, be for the real interest of the two leading commercial countries of the world. But it would require a magnanimity which must be spontaneous and which no outsider is entitled to demand.

VI

CONCLUSIONS

THE monetary problem of the world is at present so interwoven with political difficulties that it is vain to expect a definite solution until the chief political pre-requisites for stability in economic conditions have been realised. It is first of all necessary that the international indebtedness inherited from the war should be settled on such terms as satisfy the world that the debts can really be paid, and make it clear by what concrete means payment can be offered and accepted. It might therefore seem that the whole discussion of monetary questions has to be deferred to some future day. But this would be a grave mistake. The world's monetary problem involves great technical difficulties which require a thorough examination by experts and a certain amount of co-operation between the different nations. There are two principal questions to be considered: the question of the stabilisation of the internal value of currency, and the gold question. How these questions are related to one another, and to what extent they are of an international character, has been shown above. The elucidation of these questions not only is an indispensable condition of the establishment in the future of a sound basis for the world's economic

life, but also would be of great immediate utility. The experience of the past year has shown conclusively that some guidance is needed amid the confusion into which the world's monetary affairs have fallen, continued inflation on one side and excessive deflation on the other having deprived the world of every sense of equilibrium in the purchasing power of money and in international exchange.

The only way to secure such guidance within a reasonable time would seem to be to refer the whole problem, as far as it involves purely monetary questions, to a small committee of experts. In view of the central position which the United States have come to occupy since the war in all monetary affairs, and particularly in connection with the gold market, the representation of the United States on such a committee is most important. In principle, however, the committee should not represent nationalities for expert knowledge and experience. The creation of such a committee would be a sign of the willingness of the world to solve its monetary difficulties by mutual understanding and action along common lines. The feeling that the time is ripe for such action is visibly growing stronger day by day.

Printed in Great Britain by Butler and Tanner, *Frome and London*